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THE CHANGING FACE OF FOREIGN DIRECT INVESTMENT IN JAPAN:
A REPORT BY MICHAEL MCABEE*

Summary

The boom in foreign direct investment in the United States in recent years, particularly the stepped-up activities of Japanese corporate investors in the manufacturing, real estate and banking fields, has received extensive media coverage. But little attention has been paid to a parallel development -- the rapid expansion of equity investment in Japan by companies headquartered in the United States and Japan. A new study commissioned by the American Chamber of Commerce in Japan and the Tokyo-based Council of the European Business Community corrects this oversight.

Introduction

Foreign direct investment in Japan has grown an average 16 percent a year since 1980, with commitments by service-sector companies, led by foreign financial service firms, showing the highest growth rate -- an average of 21.5 percent a year since 1981. Foreign machinery makers and chemical and drug firms have been putting in capital at almost as fast a pace. Overall, foreign companies operating in Japan are not struggling for financial viability, and foreign firms no longer consider a Japanese partner essential for getting into the market.

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These are some of the major findings of a new study, the first broadly based reading in eight years of the experience and current corporate strategies of foreign affiliates operating in Japan. Sponsored by the American Chamber of Commerce in Japan (ACCJ) and the Japan-based Council of the European Business Community (EBC), the study was prepared by the Tokyo office of management consultants Booz, Allen & Hamilton, Inc., with assistance by ASI Market Research (Japan).¹

The survey combined confidential polling of almost 400 executives of foreign affiliates, selective follow-up interviews, and an analysis of Japanese, United States and European statistics related to direct foreign investment. The new study, intended to update a 1979 ACCJ study on United States manufacturing investment in Japan, was broadened to include nonmanufacturing industries and direct investments from all OECD countries as well.

Investment Pace and Climate

The foreign presence in Japan's domestic economy, seen in broad outline, has changed little in the past decade. Manufacturing industries account for roughly 60 percent of cumulative direct investment (see Table I), and U.S. companies for roughly half of that investment.

But the study reveals some changes, noted briefly above, in the pace and climate of inward capital flow that diverge sharply from the conventional wisdom about how foreign business operations are faring in Japan.

- Despite the difficulties of market entry peculiar to Japan and the sharply higher dollar cost of entry since the yen's rise starting in 1985, foreign firms are investing more than ever before in establishing or expanding a presence in Japan. Most firms do not cite Japanese government restrictions as a serious barrier to investment. Inward direct investment has grown 16 percent per year since 1980 on average, reaching a new annual high of \$938 million in 1986 (see Table II).²

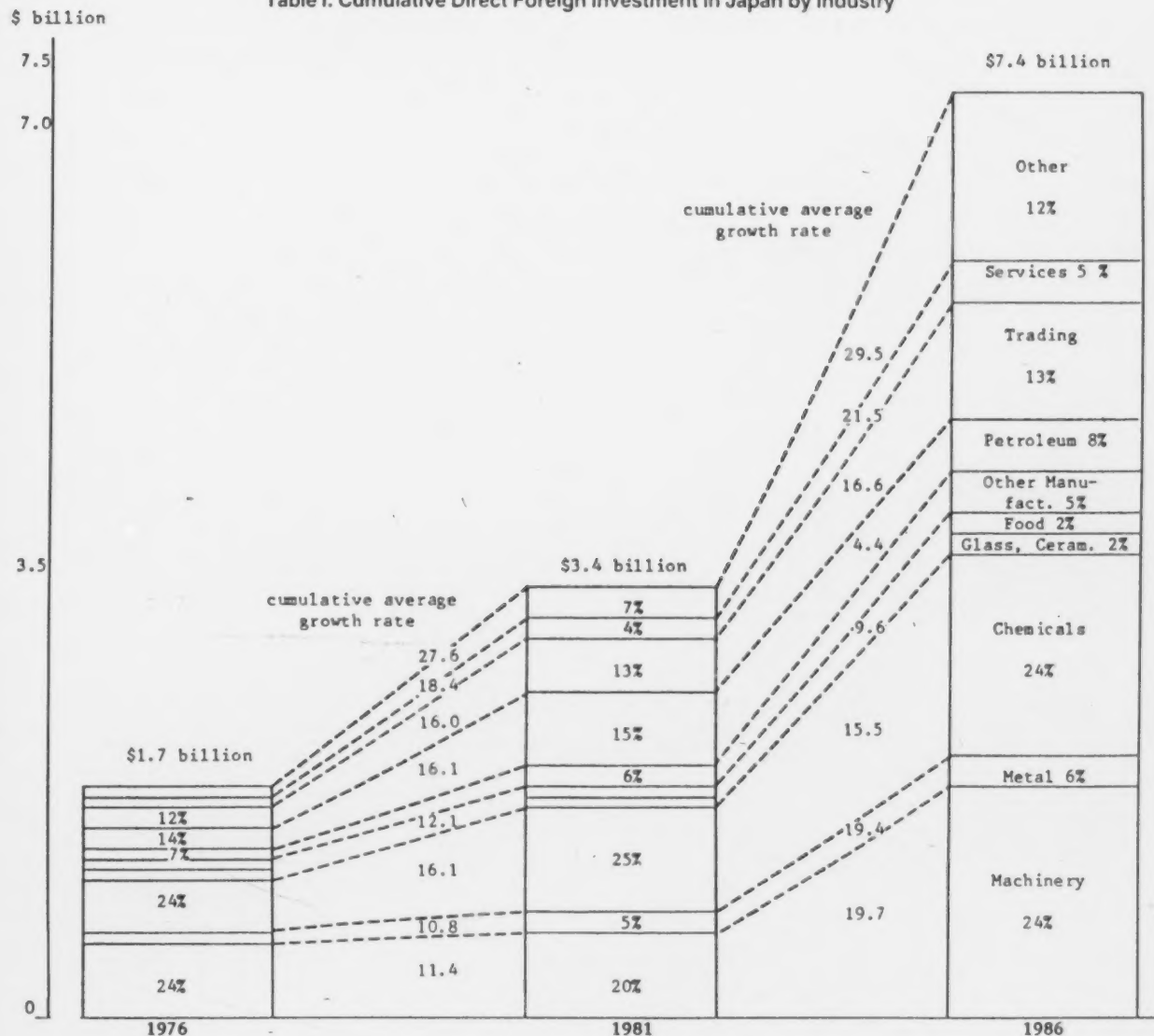
- Led by the inrush of foreign financial service firms after partial deregulation of their markets, direct investment by service-sector companies now shows the highest growth rate in resources committed to Japan (21.5 percent per year average increase since 1981). Yet foreign machinery makers -- with a far larger Japan presence in cumulative investment terms -- have been building in more capital commitment at almost as fast a pace (19.7 percent). And foreign

¹The ACCJ/EBC study, "Direct Foreign Investment in Japan: The Challenge for Foreign Firms," is available at Y3,000 per copy plus Y950 airmail or Y450 surface mail, from: The American Chamber of Commerce in Japan, Fukide Building No. 2, 4-1-21 Toranomon, Minato-ku, Tokyo 105, Japan, Attention: Mr. Henry Sampson.

²In Japan's Ministry of Finance statistics, "direct investment" includes companies in which the foreign investor has more than 10 percent ownership. Figures are based on notification of intent to invest.

chemical and drug firms, already accounting for 25 percent of cumulative inward direct investment in 1981, have maintained a brisk 15.5 percent average annual expansion of that investment.

Table I. Cumulative Direct Foreign Investment in Japan by Industry



- Additional investment by foreign firms already operating in Japan is running higher than capital commitments by newly entering firms.

- A Japanese partner is no longer viewed as essential for plugging in- to Japan's market. Until the mid-1970s, half the equity in a joint venture with a Japanese partner was the most a newly entering foreign firm could hope for under Japan's capital policy restrictions. In the latter half of the 1970s,

with free choice of entry mode, wholly foreign-owned affiliates accounted for 69 percent of foreign investment in newly established firms in Japan. This rose further to 78 percent in the period 1981-85.³

• Overall, foreign firms operating in Japan are not struggling for financial viability. Their return on equity, by Japanese statistics available up to 1983, has roughly matched the Standard & Poor's 400 level since the early 1970s, except in the recession years of 1981 and 1982. From U.S. statistics, return on investment for U.S. firms in Japan has generally exceeded or remained roughly comparable to that for U.S. firms in Europe (see Table III).

Changing Motivations

In the survey of executives on the scene, two perceptions about Japan were by far the leading reasons cited for recent decisions to boost capital commitment in the country -- that there are opportunities to expand sales and profits in Japan, and that Japan is of growing strategic importance to firms that do business worldwide.

Expanded Sales and Profits - First was the perception that the Japanese market offers opportunities to expand sales and profits. In the manufacturing sector, the survey found, the central aim of local production is to meet special requirements of Japanese customers as to quality, delivery and product aspects such as size and packaging.

For many, local production has been critical in achieving significant sales in Japan. Of the manufacturing executives queried, 53 percent claim a major increase in Japanese sales due to the decision to manufacture there. Some 34 percent plan a "significant increase" in the volume of local production over the next five years, and 46 percent expect "some increase." The survey/interview teams found that foreign firms are starting to rely more on contract manufacturing in Japan instead of building their own plants. But in such cases the company's technical development and sales/marketing investments in Japan tend to remain strong.

Unfortunately, the study does not take into consideration the "pull-through" effect of local manufacturing on exports to Japan of raw materials, parts, or related supplies to be sold along with the locally made, tailored-for-Japan items. The ACCJ's 1979 study, carried out by A.T. Kearney International, found that pull-through exports to Japan were substantial in several industries. U.S. manufacturing affiliates in both the drug and electronics/electrical machinery sectors, for example, were then importing more than 40 percent of their raw materials and parts from the U.S., either directly or via a third country. At that time, such pull-through exports from the U.S. were estimated overall at possibly \$650-\$850 million per year.

Strategic Importance - The other main catalyst for further capital input was the growing strategic importance of Japan to firms that do business on a global scale. "For many industries," said Warren Chinn, senior vice president

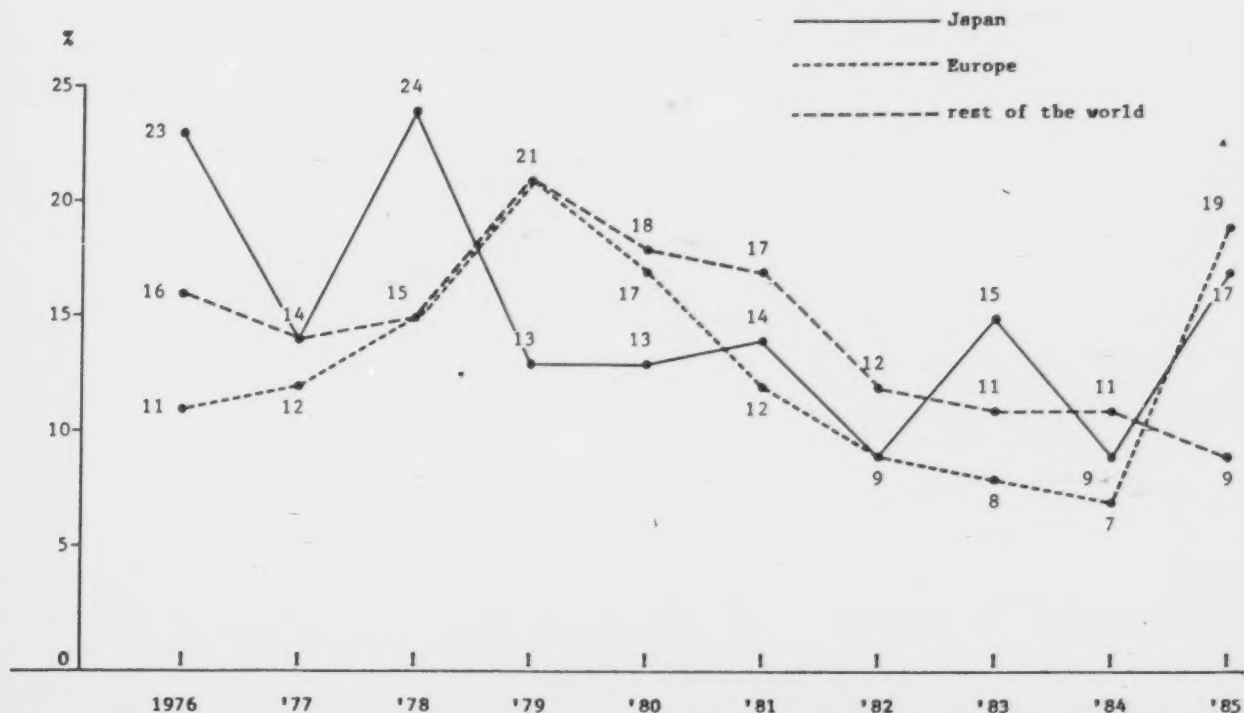
³The actual level is higher, since most new banking and securities affiliates are branches rather than incorporated companies, and as such are excluded from the Japanese statistics.

Table II: Annual Direct Foreign Investment in Japan (Equity Portion)

Year	No. of Cases	Value In US \$ Million	Year	No. of Cases	Value In US \$ Million
1950	30	2.8	1969	391	70.4
1951	38	11.6	1970	455	114.5
1952	31	7.2	1971	445	255.5
1953	22	2.7	1972	747	160.4
1954	14	2.5	1973	756	167.3
1955	9	2.3	1974	655	153.7
1956	23	5.4	1975	615	166.5
1957	22	7.3	1976	652	195.7
1958	18	3.7	1977	693	224.5
1959	21	14.6	1978	705	235.5
1960	34	31.6	1979	704	524.4
1961	41	40.2	1980	749	299.5
1962	43	22.6	1981	919	432.4
1963	92	42.7	1982	1052	749.2
1964	125	30.6	1983	2364	812.9
1965	106	44.6	1984	3685	493.5
1966	142	39.8	1985	3370	929.0
1967	200	32.2	1986	3079	938.0
1968	248	67.1			

Source: Ministry of Finance

Table III. U.S. Companies' Return on Direct Investments in Japan and Other Countries



Source: U.S. Department of Commerce and Booz, Allen & Hamilton Analysis

of Booz, Allen & Hamilton in Tokyo, "this is the most competitive market in the world. A Japan presence strengthens a foreign firm's competitive edge in its home market and other world markets." For example, demands by Japanese customers that may seem extreme may be precursors of similar demands in some of the firm's other markets.

Heavyweights in technology-driven manufacturing industries and in financial services show the greatest interest in direct investment in Japan, Chinn said. And it is affiliates of multinationals that dominate the roster of foreign businesses operating in Japan. (Among the Fortune 100 U.S. companies, for example, 70 have Japan-based operations.) Study team leader K. Rone Baldwin summed up the responses of the multinationals: "If you want to be a global player, you must have a presence in Japan."

Trend in Corporate Strategy - A growing trend in strategy among larger foreign firms, the study notes, is to restructure their Japan presence -- withdrawing from some joint ventures formed earlier with Japanese partners, increasing equity in others, and shifting functions to existing or new wholly owned operations, all aimed at consolidating control of their Japanese business. In particular, large foreign firms with a lengthy history in Japan now find they are overcoming some of the market's complexities, starting to attract top-class graduates, and are better able to fly on their own, Chinn said. In setting up new joint ventures, these companies are now much more selective in choice of partner and of functions the venture is to perform.

Global business sooner or later leads to global technology management, and in the last two years some 20 foreign companies have announced R&D centers in Japan. In some cases, the reason is that the company's leading-edge customers are in Japan, Baldwin explained. In the sharpening competition worldwide for R&D talent, some also want to try tapping such Japanese talent. Some firms surveyed noted they felt a need for a local R&D presence so as to gain adequate access to Japanese technology.

Investment Still Disproportionately Low

Foreign direct investment in Japan, despite its fast growth recently, remains disproportionately low compared to Japanese investment abroad. In 1985, Japan received only three percent of total foreign investment by U.S. companies despite its position as the world's third-largest economy. As of the same year, Japanese government figures show that direct investment abroad by Japanese companies had reached six times the cumulative investments in Japan by foreign companies. While foreign firms got a late start in Japan due to government restrictions on inward investment until the mid-1970s, Japan's own corporate investment overseas was negligible until about 1970.

Three factors were widely cited as the reasons firms already established in Japan are not increasing their capital input at a still faster pace: a long wait for profitability, and the complexity and difficulty of doing business in Japan and of recruiting good personnel.

The Wait for Profitability - First is the long time required to reach acceptable profit levels in Japan compared to alternatives in other markets. Further questioning revealed that for the affiliates surveyed, it took about four years on average to break even and about seven years to reach corporate

average profit levels. There was little difference between wholly owned operations and foreign/Japanese joint ventures in this regard.

"There is some evidence," the study comments, "that the long [wait for profitability] is more a perceived problem than a real one. . . . Although each company has its own hurdle rates for profitability, these time frames do not appear particularly long for many corporations." The real problem, the study concludes, may be uncertainty due to the rather wide range of the actual time frames that made up the averages: from 3.8 to 10 years to reach corporate average profit level in two-thirds of the cases for wholly owned subsidiaries.

Difficulty in Doing Business and Recruiting - The widely varying performance among companies in reaching profitability could well stem from the other two most often cited barriers to greater investment by foreign companies: the sheer complexity and difficulty of doing business in Japan and of recruiting good personnel.

Some fairly familiar problems are involved, such as trying to build effective sales channels in Japan's Byzantine distribution system; the strong Japanese aversion to breaking long-established ties with an entrenched supplier; and trying to establish an "insider" image in a country where outsiders -- foreign or Japanese -- are not easily accepted. Top-flight university graduates, favoring major firms, tend to see a foreign affiliate as a modest-sized newcomer rather than as the local projection of a multinational corporation, and mid-career professionals fear loss of the career development programs in which Japanese corporations blanket them should they sign on with a "profits first" foreign firm.

There is no single solution to any of these problems, but the study notes "an increasing, conscientious effort by foreign companies to win by managing themselves like Japanese companies."

Overseas Problem - Of those queried, 18 percent listed an overseas problem as their number one or number two investment barrier: lack of understanding or poor perception of opportunities in Japan by corporate management in the home country. The responses suggested that this may be a serious barrier in the transportation equipment and electronics/telecommunications industries.

Regulations and Non-Tariff Barriers - Japanese government regulations and non-tariff barriers came last, cited respectively by only 13 percent and nine percent of respondents as their most serious or next most serious restraint on further investment. But in many cases the firms of those respondents are in two of Japan's most dynamic industries: financial services and telecommunications.

Among other persisting complaints are the exclusion of foreign firms from much government procurement and contracting; a wide range of product licensing and registration requirements; import quotas and other restrictions that cripple food processors' access to imported ingredients; and limitations imposed by the government's pharmaceuticals registration system. Various forms of exclusion from the domestic business community, such as difficulty in joining Japan's ubiquitous industry associations, are also a continuing problem.

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LDP Settles Party Leadership Posts

The Liberal Democratic Party officially endorsed Noboru Takeshita as party president October 31 to succeed Yasuhiro Nakasone, who held the office for five years. Mr. Takeshita immediately named former foreign minister Shintaro Abe LDP secretary general, the number-two position, Masayoshi Ito party executive council chairman and Michio Watanabe, chairman of the policy affairs research committee.

The appointments serve to confirm the existence of a Takeshita-Abe alliance -- however fragile -- that helped launch Mr. Takeshita into the premiership November 6. Media observers roundly suspected at least an informal agreement between the two allowed Mr. Takeshita to take the top job this time in exchange for an Abe government in the future. By taking the secretary general position, Mr. Abe becomes Mr. Takeshita's logical successor when the time comes.

Mr. Watanabe also enters the ranks of future contenders by virtue of his combined party and cabinet expertise. He served at one point during the

Nakasone government as minister of International Trade and Industry. His new assignment is critical in developing the network of support necessary in LDP politics to become party president. Furthermore, the promotion boosts his leadership potential within the Nakasone faction, a significant consideration since he already is viewed as a possible heir.

Mr. Watanabe's party post has assumed growing prominence in government policymaking procedures in recent years and will allow him to make a significant impact on the new government's positions. In effect, he will oversee development of the party's stance on virtually every issue facing the Japanese government, paralleling the bureaucratic structure and indeed preparing what frequently become official government positions. Within the party, Mr. Watanabe is considered an authority on the tax code, suggesting that tax reform will be one of the most important domestic priorities of the new government.

Kiichi Miyazawa, the third of the "new leaders" who sought the LDP presidency, will be deputy prime minister under the new regime. This allows him to retain a certain amount of influence within party ranks and gives the new government the opportunity to utilize his considerable talents as a trouble-shooter if need be. It is also a facesaving gesture in the wake of his unsuccessful bid for the premiership. Mr. Miyazawa might have input through other avenues as well, since he is likely to hold onto his portfolio as finance minister in the new government.

Although the final cabinet lineup had not been announced at JEI press time, several factors will be important in drawing meanings from the new alignment, including the relative distribution by faction of important posts and the positions held by potential successors to the "new leaders." Mr. Miyazawa's retention would be a logical step in light of the current uncertainty surrounding financial markets.

Mr. Nakasone's influence in the new government could be significant in light of his potential input into a proposed government-sponsored think tank that will examine foreign policy issues and Mr. Watanabe's rise. Furthermore, Nakasone faction members are said to be contenders for the foreign minister post. Appointing a Nakasone faction member not only would demonstrate the importance of the former prime minister to the new government, but would also suggest policy continuity in Japan's foreign affairs.

Michael W. Chinworth

Liberal Democratic Party Positions
October 31, 1987

<u>Position</u>	<u>Holder</u>	<u>Age</u>	<u>Faction</u>
President	Noboru Takeshita	63	Takeshita
Secretary General	Shintaro Abe	63	Abe
Executive Council Chairman	Masayoshi Ito	74	Miyazawa
Policy Affairs Research Committee Chairman	Michio Watanabe	64	Nakasone

Factional Alignments in the Liberal Democratic Party
October 31, 1987

<u>Faction</u>	<u>Number of Members</u>
Takeshita	114
Miyazawa	89
Nakasone	87
Abe	87
Komoto	31
Nikaido	15
Neutralists*	12
Independents	10

*Former Tanaka faction members currently unaligned with any major faction.

Dollar Also Mauled By Stock Market Bears

Reflecting foreign uncertainty over the stability of the New York Stock Exchange and the economic impact of the October 19 stock market plunge, the dollar is being battered on foreign exchange markets around the globe. Paradoxically, the dollar's decline generated optimism that the United States would act decisively to curb its fiscal deficit and that the Western industrial nations would again meet to address exchange rate issues. In Japan, however, the dollar's decline cast a pall over the continuing growth of domestic demand and recent improvements in the profit pictures of export-dependent corporations.

Washington's decision to let the dollar sink appeared to be part of its strategy to stabilize markets around the globe. The Federal Reserve Board faced a difficult decision on interest rate policy immediately after the crash: if interest rates were set too high, the economy might slip into a recession; too loose a policy, on the other hand, could undermine the dollar, add to inflationary pressures and scare away the foreign investors that have been financing the U.S. budget deficit. The Fed decided to focus on preventing an economic downturn. On October 20 it announced that it would help banks meet increased liquidity demands caused by the stock market decline. Two days later major U.S. banks followed up the Fed announcement by reducing their prime lending rates by a quarter of a point, and within a week major short-term rates (such as the federal funds rate) had fallen as much as 1.5 points.

Oddly enough, the impact of these declines in exchange rates was delayed -- the dollar rose on the Tokyo interbank market from Y141.35 on October 19 to Y144.15 four days later. It was not until October 29 that the narrowed interest rate gap depressed the dollar, pushing it to its lowest level in almost 30 years, Y137.55. Although the greenback regained some ground the following day (closing at Y138.55), it fell back on November 2 to Y137.58. For several months before this time, the yen-dollar exchange rate had been relatively stable, fluctuating in a band between Y140 and Y150. Market observers speculated that this range was consistent with levels agreed to at the February meeting of the Group of Seven in Paris (see JEI Report No. 8B, February 27, 1987). When the dollar slipped below the Y140 level and the United States seemed unconcerned

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UPDATE ON JAPANESE RESEARCH AND DEVELOPMENT: SUPERCONDUCTORS

Summary

Electricity and electromagnetism are such an integral part of our everyday lives that we take the technology for granted. While these two phenomena have been harnessed for many purposes, inefficient conductors, generators and storage devices have barred wider use. Breakthroughs in superconductivity promise to sweep away these barriers and launch a second electric revolution. Researchers around the globe are racing to commercialize recently discovered high-temperature superconductors hoping to capture the lead in the high-stakes competition. This report provides an overview of recent discoveries and American and Japanese efforts to exploit them. In addition, the most recent statistics on overall Japanese research and development spending are presented in an appendix.

What is a Superconductor?

Every substance either permits electricity to flow through it (a conductor) or prevents it (an insulator) in varying degrees. (For a more detailed explanation see Appendix A.) Two characteristics define a superconductor: the ability to carry an electric current without resistance, and impermeability to magnetic fields (the Meissner effect). When an electric current flows through a normal conductor, the electrons collide with the atoms of the conductor, losing energy in the form of heat. In many cases this resistance is put to good use, in electric heating elements and transistors, for example. In other situations, the energy loss is unwanted, as in power transmission lines and electric motors. A practical superconductor would greatly increase global

energy efficiency as well as lead to new products and machines. For example, it would make a high-speed magnetic levitation train more feasible by removing the necessity for levitation magnets on the train and in the track. The active components that produce the magnetic fields could be placed in the track while the train contained only less expensive passive superconductive elements that would float on the magnetic cushion, thanks to the Meissner effect.

A Short History

The phenomenon of superconductivity was first observed in 1911 by a Dutch physicist working with lead at close to absolute zero. Until mid-1986 scientists had only managed to raise the critical temperature to 23 degrees Kelvin, or -418.27 degrees fahrenheit, using combinations of niobium and tin or titanium. To achieve these temperatures, liquid helium was used as a coolant, a relatively costly substance. In addition, the extremely low temperatures made complex, expensive containment and support structures necessary. Practical superconductors had to be able to withstand both the terrific stress of being cooled to so low a temperature and the tremendous magnetic fields that the superconductors were often built to produce -- demanding requirements not many materials could meet. The result was that superconductivity was confined to the laboratory until only recently.

Working secretly, a West German and a Swiss researcher employed by the Swiss subsidiary of International Business Machines Corp. discovered that a compound of yttrium, barium and copper exhibited superconductivity at 35 degrees Kelvin, or -397 degrees fahrenheit. The 12-degree increase (Kelvin scale) over the previous record-high critical temperature was one surprising point; previous advances had been measured in fractions of degrees. More shocking was that a ceramic oxide could be superconductive at all. Furthermore, the ceramic oxide was extremely easy to make; simply mix the ingredients in the right proportion and fire them in a kiln. Its constituent elements were also relatively inexpensive and easy to obtain.

Once the IBM pair's April 1986 results were confirmed by laboratories in the United States and Japan, a research frenzy swept the globe, resulting in rapidly rising critical temperatures. Over the course of the past year important barriers have been breached. U.S. researchers reported in early 1987 that they had developed a ceramic oxide with a critical temperature of 90 to 95 degrees Kelvin, or -298 to -288 degrees fahrenheit, opening the way to the use of less expensive liquid nitrogen (about 25 cents a gallon as opposed to \$11 for helium), which has a temperature of -320 degrees fahrenheit. A few months later U.S. and Japanese researchers found ceramic oxides that became superconductive in the astounding temperature range of 225 to 260 degrees Kelvin, or -45 to 9 degrees fahrenheit, a range within the reach of normal refrigeration equipment. The drive toward what was once a pipe dream -- room-temperature superconductors -- continued as researchers on both sides of the Pacific reported positive test results at temperatures of 65 to 75 degrees fahrenheit. Some U.S. researchers even claim to detect the key Meissner effect at 360 degrees Kelvin or 189 degrees fahrenheit.

Better But Not Perfect

The potential benefits of superconductors are enormous, ranging from faster and smaller supercomputers to vastly more efficient electric motors and generators. But they are by no means a panacea, and in fact, present several problems of their own. Although energy loss due to electrical resistance would be eliminated, superconducting elements lose energy in other ways: by generating strong magnetic fields and large emissions of radio waves. Support and peripheral structures would also have to be redesigned to take these factors into account. Superconducting components cannot be simply substituted for existing ones because the physical and electric properties are different. Beyond these generic problems, the high-temperature ceramic oxide superconductors present a wide range of unique hurdles.

- The most fundamental question is why these materials, which are insulators at room temperature, become superconductors at all. Equally important is why they become superconducting at such high temperatures. Their discovery has forced physicists to reevaluate existing theory. At present it appears that specific defects in the crystalline structure of the ceramics (a missing atom of oxygen in the matrix, or an yttrium atom where a barium atom should be) are responsible. If scientists can determine the exact cause of superconductivity, it could lead to the development of other superconducting materials.

- A related problem is called anisotropy, where a substance conducts electricity in one direction but not perpendicular to that direction. Picture the ceramic superconductor as a stack of flat sheets. Electricity can flow along the sheets from side to side, but not through the sheets from top to bottom. The consequences for forming large objects out of the new materials are obvious.

- Also relating to their crystalline structure, the ceramic superconductors have exhibited an inability to carry high electric currents relative to their physical cross-section. It is analogous to having a frictionless water pipe that can only accommodate a trickle of water -- the lack of friction becomes pointless. Household wiring, for example, has a current density of around 120 amperes per square centimeter. The new ceramic superconductors, in contrast, show only a tenth to a hundredth of this capacity. This deficiency would affect all potential uses of the ceramics, from power transmission lines to integrated circuits. (The 5 to 12 volts common in ICs may not sound like high voltage, but remember that the "wires" on an IC can be less than one ten-thousandth of a square centimeter in size.) IBM researchers have found one way around the problem. By carefully stacking layers of the ceramic, they have achieved current densities of as much as 100,000 amperes per square centimeter. Such a technique, however, may not be applicable to forming wires and cables and may prove uneconomic for producing large objects.

- Another basic problem is production. Researchers have had little success at producing superconducting ceramics in batches of more than a pound or two. If crystal defects do turn out to be the source of superconductivity, it may prove very difficult to reproduce them consistently on a large scale. Even more frustrating, the ceramics appear to be unstable. Some researchers have reported a weakening or disappearance of superconductivity in some samples after a few days.

- Like common ceramic items, the ceramic superconductors are brittle. Instead of bending under pressure, they shatter. This presents an obvious problem in producing superconducting wire or cable and in making components that would be subjected to significant physical stress.

- Ceramic superconductors are as porous as normal ceramics; foreign substances easily invade and bind to them. Unlike normal ceramics, though, the impurities render ceramic superconductors useless. This is important in several areas, of which the most significant is integrated circuits. Superconducting ICs would combine high speed with low power consumption. Since IC elements are very small (only several hundred atoms wide in the latest generation of chips) and packed very close together, it is easy for atoms to migrate from one area to another. Preventing this migration, which is already a problem for chip engineers, would become critical if ceramic superconductors were used.

- Finally, the ceramic superconductors are every bit as hard as common ceramics. This would seem to be an advantage in some cases, but it is a drawback in others. Current methods of producing ICs rely on chemical etching processes that would not be very effective on the new ceramics. On the other hand, techniques powerful enough to handle the ceramic layers could damage the non-ceramic components. This obdurate quality also translates into high costs for machining components to final tolerances. Techniques that yield net-shape forms of the ceramics may temper this problem but are subject to other drawbacks.

One possible way to avoid these problems is to find non-ceramic high-temperature superconductors. Scientists at the Massachusetts Institute of Technology discovered in June of this year that a metal alloy of barium, copper and europium became a superconductor at 90 degrees Kelvin, or -290 degrees Fahrenheit. The MIT group announced that the alloy could be turned into wire and ribbon with relative ease and would still retain superconductive traits. The advance may herald another fertile area for experimentation.

The Race To Commercialize

The discovery of high-temperature ceramic superconductors set off a whirlwind of activity around the globe. It quickly became clear that in this field, too, the United States and Japan would compete for global leadership. Strong challenges from China, European countries and even India cannot be ignored, however. As such, superconductors provide a good case study of the American and Japanese approaches to turning research and development into dollars and cents.

In broad terms, Japan has relied on cooperative efforts between government and industry that focus well-funded and -staffed efforts toward specific commercial applications. The government does bear a share of the research costs and supplies some staff and facilities, but its main contribution is persuading companies to pool their efforts and avoid duplication. Since the participants do much of the research in their own laboratories, the transfer of technology from government to industry is simultaneous with its development. In addition, the Japanese have made superconductors a top national priority, almost assuring sufficient funding and staffing for research. Although this effort is different from most Japanese government-industry projects in that money must also be spent on basic research to solve fundamental issues, it is certain that researchers will emphasize practical applications.

In contrast, the United States relies on the free market to provide incentives for the development of new products, on the assumption that markets are the best way to allocate capital and resources. While the government sponsors most military-related research, its involvement in commercial applications of scientific advances has been limited. Its biggest contribution is the vast amount of money provided to universities and the network of nine national laboratories.

The government has always left the commercialization of products up to individual companies -- companies that until recently could not combine their research activities. These efforts, therefore, are limited by the resources of each firm. This points to the biggest weakness of the U.S. research and development effort: insufficient attention to process and manufacturing technology. All the basic and developmental research is of little benefit if the technology cannot be applied on the factory floor.

In effect, the superconductor race will test the adaptability of both sides. Japan is skilled in the application of existing technology but weak in basic research, while American researchers exhibit the opposite traits. To win the race, both basic and applied research must be equally strong and coordinated.

From the standpoint of overall spending, the United States appears to have a lead. This is certainly true in terms of government spending. Washington targeted almost \$29 million for superconductor research in the year starting October 1, 1986: \$11.5 million by the Department of Defense, \$10 million by the Department of Energy, \$6.6 million by the National Science Foundation, and \$750,000 by the National Aeronautics and Space Administration. In contrast, Tokyo neglected to budget this item for fiscal 1987; the discovery came after the budget was all but enacted. A large supplementary budget passed this September, however, has given agencies leeway to start new projects. Combined with rechanneled funds, Japanese analysts estimate that government spending in FY 1987 will be about one-fourth the U.S. amount.

The story may be different in the fiscal year starting April 1, 1988, however; estimates of total requests related to superconductors go as high as Y7 billion (\$50 million at Y140=\$1.00). As for private outlays, Japanese companies may be outspending their American counterparts, at least in the short term. Japanese firms have responded quickly and have shifted significant resources into this field. American companies have mounted smaller, more cautious efforts.

Japan's Entrants: The Government

Three agencies are vying for leadership of Japan's superconductor efforts: the Ministry of International Trade and Industry, the Ministry of Education and the Science and Technology Agency. The competition among these groups for funding and control is intense. But unlike other research programs, it is possible that no agency will emerge triumphant. MITI's strength has always been in the area of commercial application of technology; MOE's responsibility has been basic research; STA most often serves as an interface between public, private and academic interest groups. Each agency's traditional role forms an equally important part of a comprehensive superconductor strategy. For a change, the agencies will have to work closely to mesh their efforts --

as challenging a task for the bureaucrats as superconductivity is for scientists. The three organizations must also deal with austere spending guidelines imposed by the Finance Ministry; preliminary totals for science and education in the fiscal 1988 budget provide for inflation and just a bit more. Juggling priorities will be difficult and all three agencies expect the bulk of funding to come from private companies.

Ministry of Education - MOE's plans are simple and straightforward: to fund research on as many projects as possible at the nation's academic institutions. It remains unclear exactly how much money can be channeled in this direction, however. A shortage of researchers with the requisite background will also hamper efforts. As in the United States, superconductor research has languished in Japanese universities for the past several years. The reaction to IBM's initial discovery shows some of the institutional problems MOE faces.

The professor in charge of superconductor research at Tokyo University refused to believe the results of the IBM experiments. He did, however, show the paper to a graduate student who eventually decided to try to disprove the IBM assertions by reproducing the experiment. Much to their surprise, the ceramic oxides did indeed exhibit superconductive behavior. Had the professor not given the IBM paper to his assistant or prevented him from reconducting the experiment, Japanese researchers would have been caught completely off-guard by the rapid research that occurred in the United States. Since then, however, the universities have mobilized their resources toward answering the many questions surrounding the new materials. How the ceramics form and why they superconduct will form the basis of commercial applications and future advances.

Science and Technology Agency - Almost immediately after the discovery of high-temperature superconductors, STA launched a series of meetings and hearings around the country, both to explain the advances and to gather opinions on further development. Although these public gatherings were derided by other ministries, they fit in well with STA's broad effort to promote creativity and innovation in Japanese society. In addition, STA inaugurated an advisory group of businessmen and academics (the New Superconductivity Materials Forum) to ponder the implications of superconductors; the forum could also breed closer cooperation between the two groups.

The agency is not without research tools of its own, of course. The Physical Chemistry Research Institute is drawing up a list of project proposals for fiscal 1988 that will almost certainly include work on applications for super-fast Josephson junctions for computers. STA also promotes research through the New Technology Development Association and the Japan Research Development Corporation. While the former concentrates on helping small entrepreneurial companies get off the ground, the latter sponsors the Exploratory Research for Advanced Technology (ERATO) project. Although only three new projects were initially slated for this fiscal year (the terahertz, morphogene and molecular architecture projects), a magnetic flux quantum computer project was hastily added this fall. The six-year project will explore applications of the new materials to digital processing. STA is expected to spend at least \$100 million over the next five years on various superconductor projects.

Ministry of International Trade and Industry - MITI is clearly the powerhouse when it comes to developing commercial applications. In addition to the 16 laboratories it operates under the banner of the Agency for Industrial

Science and Technology, MITI sponsors cooperative research programs with industry and is plugged into at least three advisory panels on superconductors. Of perhaps greater importance, it has ongoing projects ready to use the new superconductors. And officials are working with the Chinese government in a joint project to explore China's western regions for the rare earths that form the basis of the new ceramics. Until now, demand for these unusual elements has been limited. If the new superconductors prove practicable, however, current supplies of the components may prove inadequate.

MITI, though caught flat-footed by the IBM breakthrough, was the fastest to respond. By the time U.S. researchers broke the liquid nitrogen barrier, MITI's advisory committee was holding its first meetings. This committee included Nippon Telegraph and Telephone Corp., Matsushita Electric Industrial Co., Ltd., Hitachi, Ltd., Mitsubishi Electric Corp., Kyocera Corp. and Tokyo Electric Power Co., Inc. It should come as no surprise, then, that MITI-sanctioned joint research projects include these same companies.

AIST's efforts are centered around the Electrotechnical Laboratory at Tsukuba, near Tokyo. Projects on applying the new materials to Josephson junctions and super-powerful electromagnets are already in progress, with more planned for FY 1988. AIST also manages the Large-Scale Technologies for Basic Industries program, which will include a superconductor project next year within existing efforts to develop new materials. The National Institute for Research on Metals has developed a usable magnetic coil by embedding the new superconductors within more conventional metal alloys.

There are so many superconductor projects in progress or on the boards that MITI has no idea of their exact number or the amount of money involved. This is in part because existing projects have been broadened to encompass the new materials. The Moonlight energy conservation project and the Sunlight energy generation project are two of the more obvious areas of application. Projects aimed at developing small-scale cyclotrons for semiconductor production, large-scale particle colliders for basic research, and the commercialization of outer space are all interested in superconductors.

These direct efforts, however, pale in comparison to MITI's joint research programs with industry. MITI has already reactivated an old plan to develop a large-scale generating plant based on superconductors, attracting 11 companies from the electric power, electric machinery and wire industries. The eight-year project will cost well over Y30 billion (\$214.3 million), with an initial funding level of Y1.4 billion (\$10 million) in fiscal 1988. Research consortia focusing on various commercial aspects, such as wire formation, low-temperature production technology and composite technology, are likely candidates for funding. MITI continues to see its role as facilitating the conversion of basic science into commercial products. (See Appendix B for the ministry's overall strategy.) As such, it will continue to listen closely to and cooperate with industry as it pushes ahead with high-risk projects in this field.

Japan's Entrants: Industry

Not surprisingly, Japanese companies quickly realized the significance of the IBM breakthrough. Not only has industry besieged the government with advice and volunteers for joint projects, but it has redirected major resources

to exploit these discoveries. It is probably safe to say that at least part (and sometimes a good portion) of every major Japanese corporation's research department is now working on the new materials. Although this necessarily implies a great deal of duplication and other wasted efforts, the fact that the effort is so widespread is an indication of the importance corporate Japan attaches to the subject. According to a recent government survey, industry observers expect the market for applied superconductors to grow from practically nothing today to \$20 billion annually by the turn of the century. Grabbing a piece of this pie is clearly high on the business community's agenda.

Japanese firms feel they are well positioned to take advantage of the advances. Their research laboratories focus intensely on practical applications and their design and manufacturing arms work closely with the research department to bring the products quickly to market. Since process and manufacturing technologies are the key to success, the Japanese feel confident that they will be first to market. Already these firms excel in several critical areas, including wire formation techniques, ceramics, micromanufacturing and machining, semiconductor production equipment, magnetic levitation, battery technology, photovoltaics and consumer electronics.

Several firms have maintained research efforts in some fields that were abandoned by foreign competitors. NEC Corp. and Hitachi (along with MITI), for example, continued to explore Josephson junction technology after others, including IBM, had given up. Mitsubishi Electric persisted in efforts to develop a superconducting generator after Westinghouse Electric Corp. halted its experiments in 1983. Whether their past efforts will allow these firms to capitalize on the new materials, however, is unclear. But these examples are symptomatic of another Japanese strength: their willingness to take a long-term perspective and to fund lengthy efforts.

The list of companies pursuing superconductor applications is long and growing. The most interesting aspect of these activities, however, is the formation of numerous research groups with no encouragement from the government. Electric utilities and wire companies are working on wire forming technology, small optoelectronics firms have banded together for research, and even semiconductor firms are cooperating on applications. The trend could set a pattern for future endeavors, amplifying yet another Japanese strength: deep financial pockets to fund development.

In sum, it would appear that Japanese firms have redeployed their considerable forces quickly with specific targets in mind for a protracted campaign. The United States, however, is not without its own -- equally formidable -- resources.

American Companies Warm Up

While some U.S. firms are obviously excited, such as IBM, Bell Laboratories Inc. and other high technology giants, others -- including Digital Equipment Corp., American Telephone & Telegraph Co. and General Electric Co. -- are much more cautious. Although they express interest in the subject, they have not gone all-out with research support. Even when they have decided to invest, their efforts look small in comparison to Japan's: 10 to 20 researchers with moderate funding. The enthusiasm and sense of purpose are lacking. While this may indeed be the more realistic attitude, it could also unnecessarily slow development and commercialization efforts.

Nevertheless, the Japanese are awed by the fact that they are going head-to-head with the likes of IBM and Bell Labs. IBM has made key advances in the field and certainly has a trove of proprietary technology that could give it a leg up, but IBM is only one company. American firms have learned that they need to be more adept at converting laboratory advances into products, but the required changes in attitude and organizational structure have just begun. In spite of all this, the potential remains for American companies to build solid positions in their particular fields of excellence.

The U.S. venture capital industry also counts as a significant strength. Hoping to duplicate their successes in the computer and biotechnology industries, venture capitalists are hungrily eyeing the vast potential of the superconductor market. Already there are half-a-dozen start-ups using venture funds: American Superconductor Corp., Conductis, Ceramics Process Systems Corp., Monolithic Superconductors Inc. and Superconductor Technology Inc. Analysts estimate that at least \$15 million will be put into superconductor enterprises this year, with even more to come. As in the case of biotechnology, these are high-risk investments. Despite a high expected rate of attrition, venture investors are excited about the possibilities.

American Universities Turn Up The Voltage

The hottest activity is clearly taking place in the academic sector. Interestingly, it appears that the number of researchers engaged in solving the problems of commercial application are increasing very rapidly. In recent years a growing number of academics have spun off successful commercial ventures based on their university research, particularly in the computer and biotechnology fields. Whether the same pattern will apply to superconductor's remains to be seen. Building computers or mixing microbes requires a much smaller initial capital investment than producing superconducting wire or magnets.

At the same time the pursuit of answers to the fundamental questions of superconductivity is attracting scientists from related and even unrelated fields. This development is encouraging because an interdisciplinary approach may bring new insights into this field. Furthermore, an understanding of the other unusual physical properties of this group of materials (they do not shine no matter how much they are polished, for example) may open the way for advances in other areas. If U.S. scientists can answer many of the basic riddles posed by the new ceramics, they may have an edge in applying the technology in the marketplace.

Washington Takes A Hand

Worried that the superconductor competition will wind up following the pattern of earlier races that resulted in Japanese dominance in videocassette recorders and computer memory chips, Washington has decided to break the tradition of government inaction on the commercialization of technology. The shift comes at an important point in the history of federal funding for research. Before the Reagan administration took over, at least half of all federal funds were for non-defense projects. This figure has fallen to around 30 percent. While companies may be able to spin off commercial applications of technology developed with DOD money, it is more likely that the technology will be so

advanced or specific that no commercial market exists. Paradoxically, the obsession with national security may have distorted the healthy structure of research and development so important to a sound economy.

Washington's decision to support superconductor commercialization efforts is, in some ways, an indictment of the free market approach as presently practiced in the United States. Pressured by the demands of stockholders and equity markets, companies have emphasized short-term profits, cannibalizing outlays for research and development or deciding against the marginal gains of using new technologies. By addressing the often high costs of commercializing a technology, the government hopes to provide counterbalancing incentives.

At a series of June hearings, Congress heard a litany of calls for action from academia and industry. The basic thrust of the statements was that while Americans continue to make discoveries, foreign competitors are making products. In response, at least two bills have been introduced that would add \$80 to \$100 million to current spending levels. HR 3024 divides its attention equally between applied and basic research. HR 3217 takes a longer term approach by advocating a five-year program that would increase funding to universities as well as to government agencies. Unfortunately, these bills have run afoul of efforts to reduce the federal deficit. Congressional analysts say that the chances for passage are now only about 50 percent.

The president also responded to the worried tone of the congressional hearings with his own 11-point plan (see Appendix C), which includes: amending antitrust laws to permit joint production projects; increasing protection for intellectual property; a "wise men's" advisory group; establishing superconductor units or research centers at existing U.S. agencies; and expanding activities in the field within the constraints of current budgets. The president's plan makes pointed reference to Japan by calling for "reciprocal U.S. opportunities to participate in Japanese government-sponsored research and development, including superconductivity." Equally interesting, the president presented his plan at a White House-sponsored conference open only to U.S. citizens and companies.

To date, the president's plan has yielded some concrete results. The Argonne National Laboratory has been designated as a national center for superconductor research, and laboratory officials expect this to translate into increased funding of up to \$10 million. The Patent and Trademark Office has complied with Mr. Reagan's directive to expedite patent applications related to superconductivity and will grant special status to all qualifying requests.

But the government's efforts are not without controversy. Debate over whether antitrust laws should be changed is intense. Opponents of reform point to Microelectronics and Computer Corp. and Sematech Inc., two consortia organized by U.S. electronics firms, as examples of joint research under existing laws. Proponents counter that such groups are difficult and costly to organize under current rules. There even remains resistance in the private sector to the concept that the government has a positive role to play in the commercialization of technology. The debate highlights the adjustment process the American economy is undergoing in the face of strong international competition.

Outlook

Rather than trying to predict when the first products using the new high-temperature superconductors will appear (experts estimate three to five years), an appraisal of potential bilateral superconductor issues may prove more informative. The intensity of the rivalry, which developed startlingly quickly, is apparent in the explicit reference to Japan at congressional hearings and in the president's initiative, and in Japan by the strong reaction to both these actions. Three specific areas are likely to bear the brunt of the impact:

- Intellectual property disputes - Patent and copyright disputes in the electronics and biotechnology industries are harbingers of developments in the superconductor field. IBM and an American scientist have applied for basic patents covering various types of ceramic superconductors. While the exact content of the applications has not been disclosed, Japanese companies expect them to be very broad. Since a license for these patents may be vital, firms are busy building a store of applications patents to be in a strong bargaining position.

This is particularly true of Japanese companies, where standard practice is to patent all research results whether they are used or not. In addition, Japanese law encourages a large number of patent applications by keeping application fees low and by granting very narrow or specific patents. (A patent would be required for each member of a family of products, while one patent might suffice in the United States.) The Japanese patent office has reported a torrent of superconductor-related applications over the past year and officials have informally asked the companies to slow down. Responding to the already heavy workload, the government approved legislation this year that would sharply raise application fees and broaden the scope of patents. It remains to be seen, however, if the changes will have any impact on corporate applications when they go into effect January 1, 1988.

Japanese patent activity in the United States has also been steadily rising and the superconductor revolution will undoubtedly bolster this trend. Recalling previous instances when foreign companies (notably IBM and Texas Instruments Inc.) were forced to license basic technology to Japanese competitors as a condition of doing business there (something Tokyo would be unwilling and almost unable to do today because of deregulation), some Americans are alarmed at the patent mania of the Japanese companies. Indeed, some Japanese firms admit that the feverish pace is in part designed to lay a foundation for challenging competitors' patents if the need arises.

As recent court cases in the semiconductor and computer software areas have revealed, domestic and foreign intellectual property laws need to be updated and harmonized. It has always been the case, however, that the pace of legal reform has trailed the pace of technological advancement. This is all the more reason, therefore, for Washington and Tokyo to cooperate before serious problems occur.

- National security - Of equal if not greater sensitivity, this issue has been part of the U.S. policy debate from the start. Practical, high-temperature superconductors could make magnetic rail guns (which propel non-nuclear projectiles at very high velocities) and sufficiently powerful and

radiation-proof computers practical components of the president's Strategic Defense Initiative. In addition, leadership in this field is viewed as key to economic as well as military strength because of its broad potential. Fears that Washington would pour money into military but not commercial applications of the new technology while Japan does the opposite have galvanized both the administration and Congress. In fact, the Defense Department, already concerned with dependence on foreign suppliers for critical microelectronic components, has initiated an industrial competitiveness program and will probably extend it to include superconductors. As the competition progresses, Washington will be watching closely with security in mind.

• Lack of joint international research - Compared with biotechnology and electronics, the superconductor field is relatively barren of international cooperation and joint ventures. One hopes that this is simply because not enough time has passed for joint efforts to develop. Unfortunately this may not be the case -- both the United States and Japan have held conferences on the subject that have been closed to foreigners. In addition, foreigners are barred from receiving information and other resources developed by the president's superconductivity initiative. A disconcerting tone of nationalism has crept into the competition.

Tokyo is aware of this development and has taken steps to alleviate it. MITI's superconductor program will seek out foreign researchers and foreign advisors are welcome (if they can speak Japanese). In addition, MITI hopes to sponsor international seminars on the field here as well as in Japan in an effort to increase the flow of information from Japan. Critics have disparaged these actions as too little, but they far outweigh the efforts the United States has made.

Perhaps the clearest indication of trouble is the failure to agree on a new bilateral technology exchange pact (see JEI Report No. 40B, October 23, 1987). The debate surrounding the negotiations has focused on the "closed" Japanese research system compared with the "open door" practiced by the United States. While the United States would like to place more researchers in corporate laboratories, Tokyo is hardly in a position to force private companies to cooperate. The inability to compromise reflects growing U.S. frustration at solving the Japanese puzzle.

Where does this leave both sides? It appears we are on the brink of a major revolution in electric technology but also edging closer to a new round of frictions. This situation is characteristic of bilateral competition in high technology -- a situation policymakers must learn to cope with. Failure to do so might not only damage bilateral relations but also hinder technological and economic development.

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The views expressed in this report are those of the author and do not necessarily represent those of the Japan Economic Institute.

Appendix A -- Superconductivity: A Brief Explanation

A basic characteristic of every substance is the degree to which it allows a flow of electrons to pass through it; those that resist are classified as insulators while those offering little resistance are considered conductors. To understand the phenomenon of superconductivity -- the flow of electricity through a material with no resistance -- an understanding of interactions at the atomic level is necessary. Atoms are composed of a large nucleus surrounded by clouds of electrons distributed in one or more layers; different substances have different numbers of electrons in the outermost layer. An electric current is simply the movement of free electrons from atom to atom as they jump from outer electron layer to outer electron layer. If the outermost layer is full of the atom's own electrons, there is no room for a free electron to jump to; that makes the substance an insulator. If there is room for more electrons in the outermost layer, then the substance is a conductor.

Another key determinant of conductivity is the arrangement of atoms within a substance. Interactions between the outermost electron layers of each atom determine the distance between atoms and the three-dimensional arrangement of atoms within the substance, both of which influence the level of conductivity. The farther apart atoms are, the more energy it takes for an electron to jump from one to another. On the other hand, if atoms are too closely packed, the number of jumps an electron must make to travel from one end of the conductor to the other increases dramatically. Certain atomic arrangements also provide relatively straight paths for electrons to follow, while others present complicated obstacle courses.

Third, heat causes atoms to vibrate. The degree of vibration is proportional to the temperature. At -459.67 degrees Fahrenheit or absolute zero (0 degrees Kelvin), there is no thermal energy and molecular vibration stops. (Each atom's nucleus and electron cloud are still in motion, however, causing residual atomic vibration.) When cooled to near this temperature, many substances lose all resistance to an electric current, theoretically due to the absence of vibration. At such low temperatures, substances that are insulators at room temperature can become conductors and vice versa. The exact temperature needed to allow superconductivity is called the critical temperature and it varies depending on the substance involved. Current theory is barely adequate to deal with atomic interactions at these frigid temperatures.

While it is easy to forecast whether a particular pure element will be a conductor or insulator, the task is much more complex when mixtures of elements are involved. In fact, it is the interaction of elements that leads to the wide range of conductivity seen in the everyday world. We are just beginning to really understand and manipulate the electric properties of materials at the molecular level. Plastics, for example, are normally considered good insulators. Special combinations and processes, however, can produce plastics that are fairly good conductors. Our rudimentary understanding of this phenomenon is highlighted by a recently discovered new class of high-temperature superconducting materials.

Prior to the high-temperature breakthrough, scientists believed that a special combination of atomic vibration and three-dimensional atomic structure resulted in superconductivity. When cooled to close to absolute zero, the atomic vibration of various metals and alloys was reduced to the point where it became only a modest drag on the flow of electrons. In addition, the bonds between the metal atoms were just right to force a pair of free electrons into close association (not a normal condition since electrons have the same electric polarity and will thus repel each other). A superconducting current occurs as coupled electron pairs move through the atomic lattice unhindered by atomic vibration.

The new high-temperature superconductors have forced a reevaluation of theory, which predicted that superconductivity was impossible above about 40 degrees Kelvin or -388 degrees Fahrenheit. Current speculation proposes that defects in the atomic structure of ceramics and the atomic vibration of atoms combine to reinforce the vibration of free electrons, allowing them to move through the ceramic in waves without resistance. This hypothesis is very tentative, however.

Appendix B -- A Summary of the Mid-Term Report of the Industrial Superconductor Technology Development Roundtable, August 24, 1987

(unofficial translation)

Issues and Goals

I. Investigation of high-temperature and room-temperature superconductors - The discovery of ceramic oxide superconductors and the rise in critical temperatures to the level of liquid nitrogen has had a major impact on materials research. Research must be directed toward the development of room-temperature superconductors based on study of the high-temperature group. A variety of these materials with a variety of parameters must be developed so that they may be widely applied.

A. Oxidized materials - Experiments from all angles should be conducted to fully understand these materials and find ways to stabilize them. Although it is difficult to do so now, the search for other superconductors that can be cooled with liquid nitrogen should be expanded. It is therefore necessary to develop a complete theoretical understanding of these materials, including an understanding at the atomic level. This understanding will hopefully lead to the development of other classes of superconductors.

B. Organic materials - While research into raising the critical temperature of organic superconductors has just begun, it appears they are much lower than the ceramic oxides. Nevertheless, because organic superconductors offer merits in terms of stability and processing temperatures, future research is necessary. It may be that an understanding of the principles of ceramic oxides will lead to breakthroughs in the organic field.

C. Metallicized composites and alloys - At least a part of current research should be directed toward these materials. Although these materials have lower critical temperatures than ceramic oxides and will probably be commercialized after the ceramics, they offer superior physical properties that will be important.

II. Industrial and process technology - Application of superconductors in the electronics and electric power areas requires development of materials with high current densities and high magnetic fields.

A. Thin film technology - Thin films are indispensable for electronics applications. The development of multilayer superconductor technology and very thin metallicized film technology, however, may open new semiconductor manufacturing possibilities. Nevertheless, thin film superconductor technology must be pursued.

1. Understanding the basic characteristics of high-temperature ceramic oxide superconductors - This includes: thin film characteristics, the relationship between crystal and superconductive qualities, and noncrystalline and multicrystalline films.
2. Very precise control of thin film formation - Ways to control layering, purity and crystallization must be developed.
3. Production of thin films with high critical temperatures and current densities - Materials with current densities of at least 100,000 amperes per square centimeter must be developed to achieve commercialization.
4. Production of monocrystalline films - To achieve monocrystalline films, the unusual characteristics of these ceramics must be exploited. Epitaxial technology must be developed.
5. Low-temperature thin film production - Temperatures presently needed to produce the ceramics (900 degrees centigrade) are so high as to make their use with other materials difficult. The necessary temperature must be reduced to at least 450 degrees centigrade.
6. Multilayer production and design - Methods to insure the purity and stability of each layer, and new methods of exploiting this must be developed.

B. Wire formation technology - While the problem of forming the ceramics into wires is paramount, increasing the current density and magnetic field density resistance is also important. The imperfections, coherence length (the average distance between electrons in a superconductor) and free electron concentration must be understood.

1. Understanding how the imperfections in the ceramics contribute to magnetic flux density must be considered from all angles.
2. If the current density can be raised (and the materials are used in ICs), methods to prevent magnetic flux lines from changing in the chip must be found. Impurities and particles in the chip used to stop magnetic flux changes at a pin are called pinning centers. Current pinning center technology is inappropriate for the different qualities of the ceramic superconductors. New technology, perhaps based on thin films and nonmagnetic materials, must be developed.
3. It is possible that the new ceramic superconductors will solve the problem of low levels of free electrons. When both a high current density and high magnetic field resistance are needed, however, current technology is inadequate. If wires for such applications are to be developed, the following problems must be addressed:
 - a. High capacity superconducting materials technology (stability and predictability)
 - b. Understanding the relationships between electromagnetism, high current density and high voltage
 - c. High magnetic field-producing, continuous wire technology
 - d. Superconducting magnet technology
 - e. Superconductivity measurement technology

Existing production technologies, such as chemical vapor deposition and sputtering techniques for thin films as well as thin layer ceramic techniques are being tested on these problems. Perhaps use of the new superconductors with existing conductors should be tried. Finally, a technology database for this field should be created.

III. Electronics applications

- A. Device processing and manufacturing technology - Current IC production methods (lithography and etching) are inadequate. New methods suited to the electronic and physical characteristics of the ceramics must be developed. The hardness, coherence and tunneling electron qualities of the new materials pose special problems.
- B. Electric wire and component technology - Many problems must be addressed before a cheap superconductor can revolutionize common electric products. A database containing all information on the new materials would help.
- C. Research and development of entirely new devices - The unusual qualities of the new superconductors (high temperature, large electron gap, storage capacity and magnetic qualities) should be exploited in new ways.
 1. Superconducting transistors (bipolar and FET types)

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2. Superconducting measurement devices - The new ceramic superconductors can be used to make more accurate, more sensitive and smaller measurement devices, such as the superconducting quantum interference detector (SQUID). Devices to measure activity within the brain, track information networks and detect changes at the micron level are possible. Superfast detectors (sub-picosecond) should be an immediate priority.
 3. New devices - Whole families of new devices for optoelectronics and electromagnetic applications can be developed if breakthroughs on understanding the new ceramics can be made.
- IV. Energy systems - Low-loss transmission lines, supermagnetic generators, high efficiency motors, small motors, high speed motors and very large motors can be developed with practical superconductors.
1. a. Power generating equipment - Armature cores and windings will be developed in cooperation with western allies.
 - b. i. Construction of a 100-kw test plant to measure building costs.
 - ii. Measurement of efficiency gains
 - iii. Application to other motors and generators
 - c. i. Develop complementary alloys and materials
 - ii. New armature manufacturing techniques
 - iii. Develop high reliability systems
 2. Superconducting electric storage devices
 - a. The problems of ceramic oxide stability and containment of strong magnetic fields must be solved. Thyristor technology will also have to be adapted.
 - b. The United States and Japan are working on 1-5 gigawatt systems, but even bigger systems (800 megajoules and 10,000 times current capacities) must be developed.
 - c. The dynamics of cooling large coils and cores must be investigated for their mechanical, electric and magnetic effects.
 3. Superconducting cable
 - a. In addition to the problem of manufacturing a cable from the ceramic oxides, new housings and supports must be developed.
 - b. Since many countries are working on this application, an all-out effort is needed.
 - c. Methods for producing continuous high voltage lines, stable and inexpensive cables are needed.
 - d. Simplified fuses and high efficiency cooling systems are also needed.
 4. Superconducting transformers - These must be developed to complement superconducting generating and transmission systems.
 5. Superconducting magnets for nuclear fusion reactors
 - a. The high efficiency, current density and large magnetic field make superconductors ideal for nuclear fusion reactors. However, the necessary cooling equipment must be developed.
 - b. While fusion reactors are being developed, superconductors should be employed in other areas, such as magneto-hydrodynamic (MHD) generators, and other high energy systems.
 - c. Adaptation of technology developed in other areas, such as nuclear magnetic resonance (NMR) and computer-aided tomography (CAT) scanners, should be investigated.
 - d. New approaches made possible by the ceramic superconductors should be explored.
- V. Information, medical, transportation and other uses
1. High speed computers - The new ceramics will make supercomputers with system clock speeds of one nanosecond possible, while at the same time reducing their size and energy consumption. Design, manufacturing and cooling problems must be overcome.
 2. Medical systems - Smaller (perhaps portable), more sensitive, more efficient, and less expensive NMR machines should be developed. Magnetic and chemical detectors should also be explored.
 3. Magnetic-levitation train (linear motor car) - Mastery of all aspects of large-scale application of the new ceramics will be required to build a mag-lev train. Control, cooling, shielding and other large-scale phenomena must be understood.
 4. Electromagnetic naval propulsion - Large gains in energy efficiency are possible if hurdles can be overcome. Magnetic fields of 10-20 tesla will be required to drive a vessel through the water by electromagnetic repulsion and attraction. Steering, control and shielding questions must be answered.
 5. Outerspace systems - The environment of outerspace may be particularly suited to the production of ceramic superconductors. A microgravity environment solves some problems the ceramic oxides develop in the microelectronics field. Second, the ceramics themselves can be used to build more efficient space platforms and satellites, as well as for a whole range of highly sensitive space-based sensors. Scientific space exploration will surely benefit.

Policy Recommendations

I. Promotion of research and development

- A. Exploration of both the fundamental and applied aspects of the new materials must be pursued. The wide range of potential applications and the numerous problems means that the high costs of superconductor R&D must be supported by the government.
 1. Basic R&D should be the focus of the national universities and government research centers.
 2. Applied research should include development of new ceramics, clarifying physical traits, basic processing technology and other technologies.
 3. Because development of complete systems using superconductors will be expensive, cooperation with the private sector is vital.

Research topics: understanding the fundamental characteristics of ceramic superconductors; development of room temperature superconductors; development of industrial and process technology; basic superconductor research at the atomic level; development of electric power applications; applications of superconductors to basic research.

B. A structure to support superconductor research should be established.

1. Activities of the national research laboratories - Exploration of basic questions and long-term applications should be pursued. Foreign researchers should be invited to participate. A special research center should be built in Tsukuba, Chiba prefecture. National laboratories should take a leading role in this research.
2. Expanding basic research at universities - The key role of the universities in the superconductor field is revealed by the 72 papers Japanese researchers presented at the recent 18th international conference on low temperature materials. Not only must funding for university research be increased, but experiments in the areas of production, control and basic theory should be conducted.
3. National research projects - To realize the full potential of the new materials, government, academic and private research efforts must be coordinated. Because the cost of research and development is high, efforts should be concentrated in a few centers.
4. Cooperative research - In accord with the above, cooperative research should be strengthened.
5. Establishment of a support structure for private research - Although many of the private research efforts, which were initiated immediately after the ceramic breakthrough, are on the verge of some practical applications, the newness of the field presents problems. The inherently high risk calls for a coordinated, structural approach to research, including allocation of funds, researchers and expertise from all companies such as wire makers, electronics producers and ceramics firms. The effort must also include foreign researchers. This structure will be critical to the successful development of complete systems based on superconductors.
6. Patents - Because superconductor research will generate a large number of patents, it is imperative to quickly study ways to improve the current system as well as to bring it into line with international standards.

II. International cooperation and technology flows - Since the breakthrough has the potential to revolutionize every aspect of living, international competition is naturally fierce within Japan and the United States and between the two nations. Over the past year there have been instances of conferences, research exchanges and healthy scientific debate between the two countries. This "competition and cooperation" should be promoted. Japan can and should make a significant contribution to the global effort to understand and employ these new materials, sharing its knowledge with others.

- A. Joint research at national laboratories - The accumulation of first-class knowledge on superconductors at national laboratories is growing and as national research centers in other countries do, Japan's laboratories must support international cooperation. While the government is willing to support joint research and researcher exchanges, more concrete steps must be taken in the national budget. Exchange of researchers is particularly important for Japan to support. Efforts must be made to liberalize the research environment at the national laboratories as well as liberalize funding and management. The image sent to foreigners is that Japanese laboratories are closed; the level of expertise is high but the knowledge must be internationalized. Efforts to invite foreign researchers must be increased.
- B. Internationalization of national projects - Although international cooperation is already part of the government's research program it must be increased in the area of superconductors. International technology flows must be promoted. Greater foreign participation in all areas of national projects should be pursued.
- C. Disseminating national technology information through workshops and symposia - International superconductor efforts can benefit greatly from the dissemination of Japan's accumulation of technology. By holding seminars and workshops at home and abroad, Japan can accomplish this as well as improve its image.

Suggestions include: Quickly reporting research results abroad; technology transfers via international symposia and workshops; expanded exchange of researchers; and providing foreign access to Japanese databases. Since private re-

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search is advancing quickly, corporate participation in these technology transfers is vital. A study of how to encourage private participation should be started.

- D. International organizations - Existing international organizations should be enlisted in this global effort.
- III. Research surveys and other measures - To better plan improvements, a survey of current efforts and other measures should be conducted.
- A. Survey on research efforts - A survey of basic research efforts on superconductors, new materials and other related fields is needed. Efforts to apply new materials to current devices should cover all fields. The implications for society and the economy should also be studied.
- B. Survey on new applications and fields - Potential areas of application and their impact on other areas of science and technology must be explored. Creative thinking and opinions from all fields should be gathered to smooth the way for future developments.
- C. Development of measures and standards - Japan should cooperate in international efforts to establish common standards and measurements in this new field.
- D. Establishment of a database - A national database holding all relevant information would be a major asset to the research program. International access to it must also be provided.
- E. Survey of corporate efforts and support structures - A survey on industry's plans and thoughts would aid development of a national research support structure.

Source: Ministry of International Trade and Industry.

Appendix C -- President Reagan's July 21, 1987 Superconductivity Initiative

1. Amending the National Cooperative Research Act to expand the concept of a permissible joint venture to include some types of joint production ventures. This is a particularly important step that would ease the risk of antitrust litigation perceived by U.S. businesses that could otherwise benefit from pro-competitive joint ventures. If enacted, it could benefit not just developments using superconductivity, but other high technology products as well.
2. Amending U.S. patent laws to increase protection for manufacturing process patents. This would enable U.S. owners of process patents to obtain damages for infringement where products made with those processes are imported into the United States.
3. Authorizing federal agencies to withhold from release under the Freedom of Information Act commercially valuable scientific and technical information generated in government-owned and -operated laboratories that, if released, will harm U.S. economic competitiveness.
4. Establishing a "Wise Men's" Advisory Group on Superconductivity under the auspices of the White House Science Council. This would be a small group of three to five people from industry and academia that would advise the administration on research and commercialization policies.
5. Establishing a number of "Superconductivity Research Centers" and other similar groups that would conduct important basic research in superconductivity and serve as repositories of information to be disseminated throughout the scientific community.
 - a. The Department of Energy will establish three SRCs, as well as a computer data base:
 - o Center for Superconductivity Applications at the Argonne National Laboratory
 - o Center for Thin Film Applications at the Lawrence Berkeley Laboratory
 - o Center for Basic Scientific Information at the Ames Laboratory
 - o Computer Data Base on Superconductivity at the DOE Office of Scientific & Technology Information.
 - b. The Department of Commerce will establish a Superconductivity Center at the National Bureau of Standards laboratory near Boulder, Colorado. The center will focus on electronic applications of high-temperature superconductivity.
 - c. The National Aeronautics and Space Administration is establishing a coordinating group on superconductivity activities at its office of Aeronautics and Space Technology.

- d. The National Science Foundation will augment its support for research in high-temperature superconductivity programs at three of its materials research laboratories. In addition, NSF is initiating a series of "quick start" grants for research into processing superconducting materials into useful forms including wires, rods, tubes, films and ribbons.
- e. The Department of Defense is developing a multi-year plan to ensure use of superconductivity technologies in military systems as soon as possible. DOD will spend nearly \$150 million over three years.

DOD will build on its long experience in superconductivity R&D to systematically define the engineering parameters for high-temperature superconducting materials; develop the required processing and manufacturing capabilities; and accomplish the necessary development, engineering and operational prototype testing of superconductors.

Small-scale applications with commercial spin-off potential include sensors and electronics. Potential large-scale applications include compact, high-efficiency electric ship drives; electrical energy storage; pulsed power systems; and free-electron lasers.

6. Urging all federal agencies to implement quickly the steps outlined in Executive Order 12591 designed to transfer technology developed in federal laboratories into the private sector and encourage federal, university and industry cooperation in research. The White House Science Advisor will report to the president by December 1, 1987 on progress in implementing the executive order, particularly with regard to superconductivity.

7. Directing the Patent and Trademark Office to accelerate the processing of patent applications and adjudication of disputes involving superconductivity technologies when requested to do so by the applicant.

8. Directing the NBS to accelerate its efforts to develop and coordinate common standards (e.g. measurement methods, standard reference materials and supporting technical data) in the United States and internationally for superconductors and related devices.

9. Encouraging federal agencies to continue to reallocate FY 1987 funds into superconductivity basic research, applied research in enabling technologies and prototype development. Agencies are directed to place a high priority on this area in FY 1988 funding and FY 1989 planning.

10. Requesting that DOD accelerate prototype work in sensor, electronic and superconducting magnet-based military applications and that the Department of Commerce accelerate development of prototype devices in detection and measurement of weak magnetic fields.

11. Taking advantage of the opportunity presented by the current negotiations for renewing the U.S.-Japan Agreement on Science and Technology to seek reciprocal U.S. opportunities to participate in Japanese government-supported research and development, including superconductivity.

In April, the president issued Executive Order 12591, Facilitating Access to Science and Technology, directed at encouraging increased commercialization of the U.S. science and technology enterprise.

Source: Business America, August 17, 1987.

Appendix D

Table 1: Japan's R&D Expenditures, FY 1981-FY 1985

(in billions of yen and percent)

a. By Organization

<u>Fiscal Year</u>	<u>Companies</u>	<u>Research Institutions</u>	<u>Universities</u>	<u>Total</u>
1981	Y3,629.8	Y906.9	Y1,445.6	Y5,982.4
Change	15.5%	18.7%	7.9%	14.0%
Share	60.7%	15.2%	24.2%	100.0%
1982	4,039.0	949.3	1,540.4	6,528.7
Change	11.3%	4.7%	6.6%	9.1%
Share	61.7%	14.5%	23.6%	100.0%
1983	4,560.1	971.0	1,649.6	7,180.8
Change	12.9%	2.3%	7.1%	10.0%
Share	63.5%	13.5%	23.0%	100.0%
1984	5,136.6	1,033.1	1,724.2	7,893.9
Change	12.6%	6.4%	4.5%	9.9%
Share	65.1%	13.1%	21.8%	100.0%
1985	5,939.9	1,160.6	1,789.8	8,890.3
Change	15.6%	12.3%	3.8%	12.6%
Share	66.8%	13.1%	20.1%	100.0%

b. By Source

<u>Fiscal Year</u>	<u>Government</u>	<u>Private</u>	<u>Foreign</u>	<u>Total</u>
1981	Y1,612.4	Y4,363.8	Y6.1	Y5,982.4
Change	10.1%	15.6%	24.5%	14.0%
Share	27.0%	72.9%	0.1%	100.0%
1982	1,666.2	4,855.5	7.0	6,528.7
Change	3.3%	11.3%	14.8%	9.1%
Share	25.5%	74.4%	0.1%	100.0%
1983	1,721.4	5,451.1	8.2	7,180.8
Change	3.3%	12.3%	17.1%	10.0%
Share	24.0%	75.9%	0.1%	100.0%
1984	1,777.8	6,108.6	7.6	7,893.9
Change	3.2%	12.1%	-7.3%	9.9%
Share	22.5%	77.4%	0.1%	100.0%
1985	1,867.3	7,014.9	8.1	8,890.3
Change	5.0%	14.8%	6.6%	12.6%
Share	21.0%	78.9%	0.1%	100.0%

Source: Management and Coordination Agency, Report on the Survey of Research and Development.

Table 2: Japan's R&D Expenditures by Industry, FY 1984-FY 1985

(in billions of yen and percentage change)

	FY 1984		FY 1985	
	Total	Change	Total	Change
Agriculture	Y4.8	-15.5%	Y4.5	-6.1%
Mining	18.8	20.2	21.7	15.8
Construction	116.1	14.6	110.8	-4.6
Manufacturing	4,776.5	12.2	5,543.6	16.1
Food Products	123.7	11.3	133.5	7.9
Textiles	59.5	16.6	62.6	5.3
Pulp and Paper	29.1	13.3	32.4	11.2
Publishing and Printing	13.9	20.6	18.4	33.1
Chemicals	852.8	10.1	936.4	9.8
Industrial Chemicals and				
Synthetic Fibers	346.3	16.3	377.8	9.1
Oils and Paints	84.3	12.4	89.2	5.9
Pharmaceuticals	295.3	1.9	341.9	15.8
Other	127.0	13.4	127.4	0.4
Petroleum and Coal Products	56.0	12.3	68.3	21.9
Plastic Products	64.0	23.5	65.6	2.4
Rubber Products	68.4	18.4	79.8	16.7
Nonmetallic Mineral Products	131.3	15.9	174.2	32.7
Steel	192.1	3.2	240.4	25.2
Nonferrous Metals	87.7	18.5	100.5	14.7
Fabricated Metal Products	83.5	0.8	102.7	23.0
Nonelectric Machinery	337.5	8.3	382.7	13.4
Electric Machinery	1,634.5	15.4	1,938.2	18.6
Communications and Electronics				
Equipment	1,096.4	14.4	1,322.0	20.6
Other	538.2	17.6	616.2	14.5
Transportation Equipment	808.2	13.1	935.7	15.8
Motor Vehicles	686.7	13.3	797.2	16.1
Other	121.5	11.8	138.5	13.9
Precision Machinery	167.4	5.4	201.7	20.5
Other	67.0	0.9	70.6	5.4
Transportation, Communications				
and Utilities	220.5	22.3	259.3	17.6
Total	5,136.6	12.6	5,939.9	15.6

Source: Management and Coordination Agency, Report on the Survey of Research and Development.

Table 3: Japan's Ratio of Corporate R&D Expenditures to Gross Sales, by Industry, FY 1984-FY 1985

(in percent)

<u>Industry</u>	<u>FY 1984</u>	<u>FY 1985</u>
Agriculture	0.24%	0.24%
Mining	0.63	1.03
Construction	0.47	0.49
Manufacturing	2.34	2.69
Food Products	0.60	0.77
Textiles	1.16	1.18
Pulp and Paper	0.66	0.71
Publishing and Printing	0.61	0.68
Chemicals	3.46	3.79
Industrial Chemicals and Synthetic Fibers	2.47	2.80
Oils and Paints	3.09	3.14
Pharmaceuticals	6.49	7.04
Other	3.76	3.61
Petroleum and Coal Products	0.27	0.38
Plastic Products	1.94	1.75
Rubber Products	2.62	2.86
Nonmetallic Mineral Products	1.96	2.61
Steel	1.52	1.94
Nonferrous Metals	1.64	1.92
Fabricated Metal Products	1.46	1.59
Nonelectric Machinery	2.59	2.74
Electric Machinery	4.55	5.10
Communications and Electronics Equipment	4.60	5.25
Other	4.45	4.82
Transportation Equipment	2.76	2.90
Motor Vehicles	2.90	2.96
Other	2.20	2.61
Precision Machinery	4.08	4.49
Other	0.92	0.97
Transportation, Communications and Utilities	0.84	0.98
All Industry Average	1.99	2.31

Source: Management and Coordination Agency, Report on the Survey of Research and Development.

Table 4: Expenditures on Selected Science Programs, by Agency,
FY 1986-FY 1987

(in millions of yen)

	<u>FY 1986</u>	<u>FY 1987</u>
Defense Agency		
Technology development	Y65,259	Y73,286
Science and Technology Agency		
Agency research (including four air and space development organizations)	25,025	26,494
Physical Chemistry Research Institute	13,793	14,692
New Technology Development Association	1,737	2,064
Science and technology promotion survey	4,514	4,992
Space Development Association	90,659	92,648
Ocean development research	6,631	7,710
Ocean Science and Technology Center	6,437	7,516
Japan Nuclear Development Research Institute	101,556	99,462
Japan Reactor Development Center	65,925	64,289
National Nuclear Research Laboratory	1,774	1,789
Research management costs	8,497	8,942
Environment Agency		
National Disaster Research Institute	4,266	4,099
National Water-borne Disease Center	426	390
National Disaster Prevention Institute	2,625	2,474
Disaster prevention survey	883	839
Foreign Ministry		
International Atomic Energy Commission	2,578	2,531
OECD Nuclear Power Committee	181	197
Finance Ministry		
Brewing Research Institute	329	335
Education Ministry		
Ministry research (including six education centers)	6,680	6,973
Research grants	43,500	45,080
Japan Technology Promotion Council grants	3,781	4,211
Health Ministry		
Agency research (including seven population research projects)	9,858	9,867
Research grants	12,860	13,972
Radiation effects research	1,946	1,980
Health science research	2,842	3,518
Cancer research projects	1,388	1,638
International cancer research	132	105
Medical and drug information system	263	221
Agriculture Ministry		
Agency research laboratories (including 18 agricultural research centers)	44,547	44,863
Agricultural technology development	9,370	9,379
Large-scale projects	1,366	1,275
Biotechnology development	1,294	1,334
Research machinery and equipment	2,066	2,066
Agricultural technology promotion	2,090	2,090

Table 4 (continued)
(in millions of yen)

	<u>FY 1986</u>	<u>FY 1987</u>
Agriculture Ministry (continued)		
Agricultural machinery research	Y810	Y813
Red tide research	224	234
Food product technology	602	505
International Trade and Industry Ministry		
Agency research (including 15 research centers)	25,176	25,515
Large-scale industrial technology projects	5,275	4,504
Computer industry promotion projects	4,501	4,051
Next-generation basic technology projects	5,644	4,850
New energy technology projects	2,378	2,010
Energy conservation projects	1,026	760
Private transportation project (YXX aircraft)	714	714
Private aircraft jet engine project (V2500)	3,987	3,987
Small business technology improvement	1,397	2,002
Transportation Ministry		
Agency research (including four ship technology centers)	7,168	7,252
Geostationary weather satellite management	2,032	2,126
Geostationary weather satellite launches	2,167	3,246
Magnetic levitation train technology	300	295
Posts and Telecommunications Ministry		
Electrotechnical laboratories	4,126	4,037
Construction Ministry		
Agency research (including one engineering center)	4,435	4,497

Source: Management and Coordination Agency, Report on the Survey of Research and Development.

Table 5: Japanese Government R&D Expenditures, FY 1986

(in millions of yen and percentage change)

	<u>Science Promotion</u>	<u>Energy Research</u>	<u>Other Research</u>	<u>Special Research</u>	<u>Total</u>
Diet	Y517 0.0%	YO --	YO --	YO --	Y517 0.0%
Japan Technology Council	0 --	0 --	863 -2.8%	0 --	863 -2.8%
Police Agency	899 6.1%	0 --	0 --	0 --	899 6.1%
Hokkaido Development Agency	142 0.7%	0 --	0 --	0 --	142 0.7%
Defense Agency	0 --	0 --	66,133 12.7%	0 --	66,133 12.7%
Economic Planning Agency	704 0.1%	0 --	0 --	0 --	704 0.1%
Science and Technology Agency	154,277 5.0%	167,708 1.2%	8,497 -49.7%	89,860 7.2%	420,342 1.7%
Environment Agency	8,320 -2.4%	0 --	0 --	0 --	8,320 -2.4%
L. Agency	210 -29.8%	0 --	0 --	0 --	210 -29.8%
Justice Ministry	808 2.7%	0 --	0 --	0 --	808 2.7%
Foreign Ministry	0 --	2,578 -2.1%	4,017 10.6%	0 --	6,594 5.2%
Finance Ministry	329 3.2%	0 --	0 --	610 5.5%	938 4.7%
Education Ministry	57,745 3.3%	0 --	124,807 0.9%	563,039 5.4%	745,591 4.5%
Health Ministry	28,015 6.4%	0 --	1,251 -3.5%	6,856 11.8%	36,121 7.0%
Agriculture Ministry	60,733 2.0%	0 --	1,944 12.6%	3,800 *	66,477 8.5%
International Trade and Industry Ministry	56,427 -4.5%	3,404 -22.7%	10,675 -0.9%	147,050 18.2%	217,557 9.5%
Transportation Ministry	11,511 1.0%	0 --	571 -0.6%	1,188 2.0%	13,271 1.0%
Posts and Telecom- munications Ministry	4,126 -2.0%	0 --	41 -16.1%	20,500 105.0%	24,667 73.0%
Labor Ministry	599 2.4%	0 --	1 0.0%	2,371 5.8%	2,970 5.1%
Construction Ministry	5,065 3.1%	0 --	751 177.5%	0 --	5,817 12.2%
Home Affairs Ministry	527 2.5%	0 --	0 --	0 --	527 2.5%
Total	390,954 2.5%	173,690 0.6%	219,551 0.5%	814,773 8.3%	1,598,969 4.8%

*New allocation

Source: Management and Coordination Agency, Report on the Survey of Research and Development.

Table 6: Japanese Government R&D Expenditures, Planned FY 1987

(in millions of yen and percentage change)

	<u>Science Promotion</u>	<u>Energy Research</u>	<u>Other Research</u>	<u>Special Research</u>	<u>Total</u>
Diet	Y525 1.5%	Y0 --	Y0 --	Y0 --	Y525 1.5%
Japan Technology Council	0 --	0 --	856 -0.8%	0 --	856 -0.8%
Police Agency	925 2.9%	0 --	0 --	0 --	925 2.9%
Hokkaido Development Agency	143 0.6%	0 --	0 --	0 --	143 0.6%
Defense Agency	0 --	0 --	74,135 12.1%	0 --	74,135 12.1%
Economic Planning Agency	710 0.8%	0 --	0 --	0 --	710 0.8%
Science and Technology Agency	160,765 4.2%	163,966 -2.2%	8,942 5.2%	91,559 1.9%	425,232 1.2%
Environment Agency	7,914 -4.9%	0 --	0 --	0 --	7,914 -4.9%
Land Agency	160 -23.7%	0 --	0 --	0 --	160 -23.7%
Justice Ministry	806 -0.3%	0 --	0 --	0 --	806 -0.3%
Foreign Ministry	0 --	2,531 -1.8%	3,767 -6.2%	0 --	6,298 -4.5%
Finance Ministry	335 1.9%	0 --	0 --	674 10.5%	1,009 7.5%
Education Ministry	59,759 3.5%	0 --	126,172 1.1%	594,243 5.5%	780,174 4.6%
Health Ministry	29,886 6.7%	0 --	1,225 -2.0%	8,649 26.2%	39,761 10.1%
Agriculture Ministry	61,098 0.6%	0 --	1,851 -4.8%	3,800 0.0	66,748 1.8%
International Trade and Industry Ministry	54,527 -3.4%	2,770 -18.6%	11,574 8.4%	152,538 3.7%	221,409 1.8%
Transportation Ministry	12,758 10.8%	0 --	754 32.0%	1,004 -15.5%	14,516 9.4%
Posts and Telecom- munications Ministry	4,037 -2.1%	0 --	5 -88.0%	25,000 22.0	29,042 17.7%
Labor Ministry	601 -0.4	0 --	0.7 0.0%	3,033 27.9%	3,635 22.4%
Construction Ministry	5,149 1.7%	0 --	356 -52.6%	0 --	5,506 -5.3%
Home Affairs Ministry	536 1.6%	0 --	0 --	0 --	536 1.6%
Total	400,634 2.5%	169,267 -2.5%	229,639 4.6%	855,500 5.0%	1,655,040 3.5%

Source: Management and Coordination Agency, Report on the Survey of Research and Development.

Table 7: Japan's Technology Imports, FY 1950-FY 1985

(number of approved cases and value in billions of yen)

	<u>Cases</u>		<u>Value</u>	
	<u>Total</u>	<u>Of Which New:</u>	<u>Total</u>	<u>Of Which New:</u>
FY 1950-55	1,148	n.a.	Y24.9	n.a.
FY 1960	588	n.a.	34.2	n.a.
FY 1965	958	n.a.	60.1	n.a.
FY 1970	1,768	n.a.	155.9	n.a.
FY 1975	6,766	796	169.1	Y13.3
FY 1976	6,050	632	177.3	17.9
FY 1977	6,659	685	190.1	16.9
FY 1978	6,573	936	192.1	38.2
FY 1979	7,012	1,020	241.0	26.8
FY 1980	7,248	919	239.5	27.7
FY 1981	7,207	844	259.6	24.9
FY 1982	6,936	929	282.6	44.4
FY 1983	7,839	1,073	279.3	42.4
FY 1984	7,316	982	281.4	31.8
FY 1985	7,679	1,245	293.2	33.3

Table 8: Japan's Technology Exports, FY 1950-FY 1985

(number of approved cases and value in billions of yen)

	<u>Cases</u>		<u>Value</u>	
	<u>Total</u>	<u>Of Which New:</u>	<u>Total</u>	<u>Of Which New:</u>
FY 1950-55	n.a.	n.a.	Y0.3	n.a.
FY 1960	n.a.	n.a.	0.8	n.a.
FY 1965	n.a.	n.a.	6.1	n.a.
FY 1970	861	n.a.	21.2	n.a.
FY 1975	2,811	1,073	66.6	Y18.9
FY 1976	2,767	775	83.4	27.0
FY 1977	2,880	897	93.3	36.3
FY 1978	3,157	1,063	122.0	47.1
FY 1979	3,667	1,087	133.1	52.1
FY 1980	4,103	1,237	159.6	74.3
FY 1981	4,877	2,017	175.1	70.8
FY 1982	4,738	1,970	184.9	63.3
FY 1983	6,403	2,494	240.9	74.9
FY 1984	5,426	1,824	277.5	90.9
FY 1985	5,885	2,099	234.2	73.3

Source: Management and Coordination Agency, Report on the Survey of Research and Development.

Table 9: U.S. Patents Applied For and Granted, 1978-86

(cases)

	<u>Applications</u>		<u>Granted</u>	
	<u>Total</u>	<u>By Japan</u>	<u>Total</u>	<u>To Japan</u>
1978	109,300	10,400	70,500	7,100
1979	106,900	11,100	52,400	5,800
1980	113,000	13,100	66,200	6,600
1981	114,500	14,400	71,000	8,500
1982	118,400	17,300	63,300	8,800
1983	112,400	15,700	62,000	8,600
1984	117,985	18,289	72,149	11,355
1985	125,931	21,699	75,302	12,783
1986	131,403	24,292	76,993	13,644

Source: U.S. Patent Office

Table 10: Japanese Patents Applied For and Granted, FY 1978-FY 1985

(cases)

	<u>Applications</u>		<u>Granted</u>	
	<u>Total</u>	<u>By the U.S.</u>	<u>Total</u>	<u>To the U.S.</u>
FY 1978	166,100	10,300	45,500	4,000
FY 1979	174,600	9,900	44,100	4,600
FY 1980	191,000	10,400	46,100	4,000
FY 1981	218,300	12,000	50,900	4,500
FY 1982	237,500	14,200	50,600	4,100
FY 1983	255,000	16,000	54,700	4,200
FY 1984	284,767	18,030	61,800	4,100
FY 1985	302,995	22,633	50,100	3,100

Source: Japanese Patent Agency

Table 11: Japan's Corporate Technology Trade by Industry, FY 1984-FY 1985

(number of cases and value in billions of yen)

	FY 1984				FY 1985			
	Exports		Imports		Exports		Imports	
	Cases	Value	Cases	Value	Cases	Value	Cases	Value
Total	5,426	Y277.5	7,316	Y281.4	5,885	Y234.2	7,679	Y293.2
Agriculture	18	0.2	0	0.0	8	0.2	0	0.0
Mining	15	0.4	14	0.2	17	0.4	22	0.2
Construction	712	44.6	307	2.3	384	26.5	380	3.5
Manufacturing	4,660	231.9	6,979	276.9	5,449	205.6	7,265	288.6
Food Products	175	6.8	178	9.5	113	6.1	81	10.4
Textiles	106	3.9	215	9.4	152	4.0	233	3.3
Pulp and Paper	47	1.4	36	1.4	43	1.1	38	1.6
Publishing	12	0.1	33	0.5	17	0.1	49	0.6
Chemicals	888	37.5	784	40.8	972	38.2	810	37.4
Synthetic Fibers	421	19.1	429	15.3	452	19.8	427	13.6
Fertilizers	169	2.6	153	3.7	180	2.3	133	3.7
Pharmaceuticals	204	13.7	123	13.8	239	13.1	166	13.1
Other	94	2.1	79	7.9	101	3.1	84	7.1
Petroleum and								
Coal Products	31	0.6	97	3.0	9	0.6	99	5.2
Plastic Products	57	0.5	92	1.6	66	1.2	118	3.1
Rubber Products	53	2.3	118	3.3	61	2.7	112	3.2
Nonmetallic Mineral								
Products	196	11.2	186	8.4	344	9.5	287	32.4
Steel	411	32.4	316	5.6	393	26.2	274	4.7
Nonferrous Metals	133	1.9	170	5.1	162	1.9	200	5.1
Fabricated Metal								
Products	133	1.3	199	3.6	152	2.4	209	3.9
Nonelectric								
Machinery	543	11.4	1,109	23.9	588	11.7	979	24.5
Electric								
Machinery	1,095	47.2	2,190	94.9	1,439	59.5	2,481	84.2
Machine Tools	434	14.2	437	33.7	517	17.7	425	24.1
Electronics	661	33.0	1,753	61.2	922	41.7	2,056	60.1
Transportation								
Equipment	526	39.8	883	55.2	777	32.4	873	59.7
Motor Vehicles	304	27.2	271	10.3	558	26.0	284	11.4
Other	222	12.6	612	45.0	219	6.4	589	48.3
Precision Machinery	71	1.8	191	4.4	57	1.7	266	5.1
Other	183	31.7	182	6.3	104	6.3	156	4.3
Transportation, Com-								
munications, and								
Utilities	21	0.4	16	2.1	27	1.6	12	0.9

Source: Management and Coordination Agency, Report on the Survey of Research and Development.

Table 12: Japan's Corporate Technology Trade by Country, FY 1982-FY 1985

(number of cases and value in billions of yen)

a. Exports

	FY 1982		FY 1983		FY 1984		FY 1985	
	Cases	Value	Cases	Value	Cases	Value	Cases	Value
Asia	2,470	Y111.6	3,084	Y119.2	2,549	Y112.5	3,047	Y87.5
China	101	4.5	236	18.4	918	53.1	976	34.3
Taiwan	447	9.7	655	10.8	512	10.0	559	7.9
Korea	485	7.5	903	17.0	598	14.9	798	18.2
Thailand	229	5.6	287	6.1	218	8.3	214	6.2
Philippines	127	2.3	131	13.5	111	0.6	320	4.4
Indonesia	227	14.8	273	15.8	228	13.6	174	5.2
North America	784	40.8	1,226	60.0	944	71.9	1,058	58.7
United States	654	35.6	1,069	53.6	751	65.9	896	51.8
South America	220	10.8	238	10.1	199	3.7	243	8.7
Brazil	110	7.3	133	7.9	107	1.9	133	3.3
Europe	835	39.0	1,597	37.1	993	40.7	1,072	45.5
Great Britain	118	8.4	469	5.3	168	6.8	183	5.3
West Germany	152	4.7	431	5.1	217	4.7	253	11.3
France	121	3.9	144	4.5	141	4.6	129	4.8
Netherlands	31	1.0	46	2.4	38	2.1	41	4.8
Switzerland	58	2.1	52	2.1	42	4.9	44	3.3
Africa	314	12.4	137	9.2	222	12.8	135	6.6
Oceania	115	5.5	121	5.3	133	5.1	163	13.0

b. Imports

	FY 1982		FY 1983		FY 1984		FY 1985	
	Cases	Value	Cases	Value	Cases	Value	Cases	Value
Asia	111	Y0.7	10	Y0.2	63	Y0.3	169	Y0.9
China	1	*	3	*	53	0.2	115	0.8
Taiwan	1	*	2	*	51	0.1	1	*
Korea	41	0.5	1	*	8	0.1	52	0.0
North America	4,158	188.6	4,757	194.0	4,437	194.0	4,814	210.3
United States	4,062	187.0	4,698	191.1	4,335	193.0	4,772	208.6
South America	1	*	3	*	26	0.0	1	*
Europe	2,618	92.7	3,025	84.5	2,750	86.7	2,664	81.6
West Germany	803	17.8	832	19.6	975	17.8	859	17.6
Great Britain	462	25.0	480	14.7	429	13.2	566	14.6
France	333	10.9	401	11.4	374	10.4	285	6.8
Switzerland	326	15.7	335	15.9	269	16.0	319	16.3
Netherlands	150	12.7	151	11.3	156	14.1	156	15.5
Africa	5	0.3	4	*	5	0.0	1	*
Oceania	43	0.4	40	0.4	33	0.3	28	0.3

*Less than Y50 million.

Source: Management and Coordination Agency, Report on the Survey of Research and Development.

J A P A N · E C O N O M I C · I N S T I T U T E

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The New Cabinet: Political Balance And Policy Continuity

The cabinet of newly installed Prime Minister Noboru Takeshita reflects a delicate balance of intra-party politics and policy considerations. With six seats in the new government, the Takeshita faction holds a slight plurality, but in terms of qualitative representation the faction of former Prime Minister Yasuhiro Nakasone fared extremely well, capturing the Foreign Affairs, Posts and Telecommunications, and Construction ministries. With this heavy representation in key positions, Mr. Nakasone's influence on the new government could be significant, although it is not likely to be dominant. Both the Abe and Miyazawa factions landed four positions of generally comparable status in the

new government. Abe faction member Takashi Sato is the new agriculture minister, an important post for anyone with ambitions for the future. Miyazawa supporter Tsutomu Kawara is the new Defense Agency director general, another position that has grown in stature in recent years in response to significant changes in defense policies.

Mr. Takeshita apparently was sensitive to the perception abroad that he lacks international experience, since Kiichi Miyazawa was retained as finance minister. Mr. Miyazawa reportedly sought to remain in his post for both personal and policy reasons. His reappointment signals the likelihood of policy continuity in Japan's fiscal and monetary policies. By the same token, the new government's foreign policies are likely to remain consistent at least for the short term with the appointment of a Nakasone loyalist as foreign minister. In commercial and trade policies the same principle holds true, with Hajime Tamura staying on as head of the Ministry of International Trade and Industry.

Mr. Kawara's appointment as JDA director general is an interesting one. As the price of support for the Nakasone government when it was first formed, Zenko Suzuki, the head of the faction now led by Mr. Miyazawa, reportedly insisted that the JDA director general be a member of his group, which was perceived as having less hawkish leanings. Both the agency's heads in the Nakasone government -- Yuko Kurihara and Koichi Kato -- entered the positions as respected, articulate "doves" on defense policies. It appears that the Miyazawa faction has inherited that logic in having one of its members named to the position under the Takeshita government. Although less is known about Mr. Kawara's inclinations since this is his first time as a cabinet appointee, it can be assumed that he is likely to follow the cautious stance of both Mr. Suzuki and Mr. Miyazawa toward defense policies (he served as deputy chief cabinet secretary under then Prime Minister Suzuki), while sustaining the general direction of current policies.

Takeshita loyalist Keizo Obuchi is the government's new chief cabinet secretary, under any circumstances an important position but one likely to be even more central to the policymaking process in a government headed by an individual known more for his consensus-building skills than his policy initiatives. One interesting appointment is that of Abe faction member Shintaro Ishihara, once a somewhat controversial figure because of his staunch nationalism. As the new transportation minister, he has an opportunity to gain a larger national and intra-party following. Finally, the faction of Toshio Komoto is represented in only two positions -- the Ministry of Health and Welfare and the Science and Technology Agency -- reflecting the marginal impact of the faction on the outcome of the Liberal Democratic Party presidential race in October.

Media commentaries in both Japan and the United States have correctly noted that -- for better or worse -- the new cabinet alignment indicates an emphasis on policy continuity on virtually every domestic and international front. Clearly, the most important priority in the domestic arena is pursuit of tax reform, while international relations demand attention on several fronts, including South Korea, the People's Republic of China and the United States. Mr. Takeshita might try to seize the momentum in these foreign policy areas through personal visits to each country early in the new year. Finance Minister Miyazawa has been outspoken on the direction of international financial policies and the responsibilities of the United States to rectify its own

problems before demanding more of Japan. While it is likely that many -- if not most -- Japanese policymakers and business groups share these perceptions, this is not necessarily an indication of a new "hard line." More likely, it suggests a degree of autonomy for members of the cabinet. This is a problem that could baffle the regime for months to come, since three prominent members of the ruling LDP are directly or indirectly involved in the government.

The cabinet alignment, nevertheless, is a transitional arrangement representing policy considerations and political expedience. Mr. Takeshita is bound by the support of other major faction leaders in the LDP, just as Mr. Nakasone was linked with Kakuei Tanaka in the early days of his government. Mr. Takeshita's challenge will be to establish an independent power base and distance himself from at least one of the other three LDP power blocs in the next year. If he succeeds, it is a virtual certainty that the cabinet will be reshuffled within the next twelve months. The question then is to whom the prime minister remains beholden for his office.

Michael W. Chinworth

The First Takeshita Cabinet

November 6, 1987

<u>Position</u>	<u>Name</u>	<u>Age</u>	<u>Faction</u>
Prime Minister	Noboru Takeshita	63	Takeshita
Deputy Prime Minister	Kiichi Miyazawa	68	Miyazawa
Finance	Kiichi Miyazawa	68	Miyazawa
Justice	Yukio Hayashida	71	Miyazawa
Foreign Affairs	Sosuke Uno	65	Nakasone
Education	Gentaro Nakajima	58	Abe
Health and Welfare	Takao Fujimoto	56	Komoto
Agriculture, Forestry and Fisheries	Takashi Sato	59	Abe
International Trade and Industry	Hajime Tamura	63	Takeshita
Transportation	Shintaro Ishihara	55	Abe
Posts and Telecommunications	Masaaki Nakayama	55	Nakasone
Labor	Taro Nakamura	69	Takeshita
Construction	Ihei Ochi	66	Nakasone
Home Affairs	Seiroku Kajiyama	61	Takeshita
State Ministers			
Chief Cabinet Secretary	Keizo Obuchi	50	Takeshita
Management/Coordination Agency	Osamu Takatori	58	Takeshita
National Land Agency	Seisuke Okuno	74	Unaligned
Japan Defense Agency	Tsutomu Kawara	50	Miyazawa
Economic Planning Agency	Eiichi Nakao	57	Nakasone
Science and Technology Agency	Soihiro Ito	63	Komoto
Environmental Protection Agency	Tohio Horiuchi	69	Abe
Okinawa/Hokkaido Development Agencies	Shigeru Kasuya	61	Miyazawa
Cabinet Legislative Bureau	Osamu Mimura	63	Unaligned

is, of course, not unlimited and an appreciating yen reduces the level of aggregate demand in the economy overall. Whether the EPA findings will stand up in the face of further increases in the value of the yen remains to be seen. EPA used a value of $Y137=\$1.00$ to reach its conclusions regarding rationalization, for example. At JEI press time the dollar was below that.

Douglas Ostrom

Japan's Current Account Surplus Turns The Corner

Buried under the late October avalanche of stories about the gyrations of the New York and Tokyo stock markets and the dollar's tumble was some more upbeat economic news from Japan: the 1987 current account surplus -- rather than topping last year's \$85.9 billion number as analysts were predicting as recently as three months ago -- should come in slightly below that record. Although the surplus had shrunk on a year-to-year basis in the April-June period, the decline was too slight for economists to state unequivocally that the string of 18 consecutive quarterly increases had been broken for good. But the July-September figures proved that the corner has in fact been turned since at \$20.9 billion the balance in merchandise trade, services and transfers was one-seventh below the comparable 1986 figure (see Table 1). With all signs pointing to an even bigger fourth quarter drop, Japan's current account surplus this year is likely to fall at least \$1 billion shy of the all-time high.

Even the worst-case scenario is not as bad as it was in late summer since a straight-line extrapolation of the data through September puts the 1987 surplus at \$86.1 billion -- only \$0.2 billion more than last year's imbalance. Most analysts have linked this improvement to the impact of the appreciating yen on Japan's trade surplus, which finally contracted on a balance of payments basis (imports valued f.o.b. rather than c.i.f. as in the more widely used customs clearance trade numbers) in the July-September period after also chalking up gains for 18 consecutive quarters (see JEI Report No. 40B, October 23, 1987). But equal billing should be given to the bigger services deficit. Thanks to the strong yen, overseas travel by Japanese has soared this year. These trips have produced a record deficit in the combined travel and passenger transportation category in each of the first three quarters and pushed Japan's services trade deficit deeper into the red despite a continuing jump in the quarterly numbers for net investment income.

While the new balance of payments figures confirmed that Japan's quarterly current account surplus did peak in the April-June period, they also detailed what securities markets around the world already knew -- that Japanese financial institutions had reduced their overseas exposure during this time, while foreign investors had increased their net holdings of Japanese bonds. July's net long-term capital outflow of \$18.5 billion was just short of the monthly record set in June (\$19.2 billion). But then the net outflow slowed to a trickle, dropping to only \$1.4 billion in August and \$2.3 billion in September. Net Japanese purchases of foreign bonds fell from \$8.9 billion in July to a mere \$2 billion in September, although net purchases of offshore (mainly American) stocks remained brisk (see Table 2). At the same time, falling bond prices in Japan and expectations of a stronger yen led to back-to-back record net bond purchases by foreigners of \$3.3 billion in August and \$3.4 billion in September.

Susan MacKnight

Table 1: Japan's Balance of Payments

(in millions of dollars)

	<u>Trade Balance</u>	<u>Exports (f.o.b.)</u>	<u>Imports (f.o.b.)</u>	<u>Services (net)</u>	<u>Current Account Balance</u>	<u>Long-Term Capital (net)</u>
1982	\$18,079	\$137,663	\$119,584	\$-9,848	\$6,850	\$-14,969
1983	31,454	145,468	114,014	-9,106	20,799	-17,700
1984	44,257	168,290	124,033	-7,747	35,003	-49,651
1985	55,986	174,015	118,029	-5,165	49,169	-64,542
1986	92,827	205,591	112,764	-4,932	85,845	-131,461
1986:I	14,552	44,813	30,261	-1,145	12,668	-18,990
1986:II	23,922	52,270	28,348	-374	23,099	-28,882
1986:III	26,793	53,859	27,066	-1,922	24,413	-38,410
1986:IV	27,560	54,649	27,089	-1,491	25,665	-45,179
1987:I	23,373	50,515	27,142	-1,348	20,962	-32,209
1987:II	25,038	55,823	30,785	-1,601	22,762	-44,365
1987:III(p)	23,600	56,596	32,996	-2,089	20,860	-22,210

Source: Bank of Japan

Table 2: Japanese Net Purchases of Foreign Securities

(in millions of dollars)

	<u>Bonds</u>			<u>Stocks</u>		
	<u>Purchases</u>	<u>Sales</u>	<u>Net</u>	<u>Purchases</u>	<u>Sales</u>	<u>Net</u>
1982	\$16,980	\$10,904	\$6,076	\$1,126	\$975	\$151
1983	22,905	10,400	12,505	2,106	1,445	661
1984	56,348	29,575	26,773	1,570	1,519	51
1985	291,338	237,859	53,479	5,484	4,489	995
1986	1,346,989	1,253,965	93,024	20,917	13,869	7,048
1986:I	251,591	234,330	17,261	2,793	1,961	832
1986:II	368,271	343,467	24,804	3,717	2,260	1,457
1986:III	357,331	330,980	26,351	6,481	4,473	2,008
1986:IV	369,796	345,188	24,608	7,926	5,175	2,751
1987:I	377,850	354,648	23,202	13,925	9,386	4,539
1987:II	341,880	316,585	25,295	15,277	9,797	5,480
1987:III(p)	325,517	308,421	17,096	21,882	18,369	3,512

Source: Bank of Japan

J E I

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JAPAN, AGRICULTURE AND THE MTN

Summary

Japan is the single largest buyer of U.S. agricultural exports, accounting for close to 20 percent of foreign sales in recent years. It is also the world's biggest net importer of farm commodities. But Japan's pivotal role in international agricultural trade will not exempt it from the U.S.-led drive in the Uruguay Round of multilateral trade negotiations for new rules governing world trade in agriculture. Improved market access and changes in domestic farm policies that distort trade top the agenda for the MTN agriculture talks and these are both areas where Japan has come under fire from major exporters.

Tokyo has agreed not only to put its agriculture programs on the negotiating table in Geneva but to consider reforms as well. This flexibility is one of the first signs of change in Japan's agricultural policy position. Others are certain to follow, but they might not come fast enough to avert a clash with the United States and other big farm exporters in the MTN. How Tokyo and Washington handle issues related to Japan's import quotas in the coming weeks and months could be an early indication.

Writing New Agricultural Trade Rules

The international agricultural trading system has broken down under the weight of chronic global overproduction and pervasive predatory export policies. Despite a lot of finger pointing, policymakers in both industrial and developing countries agree on this point. More important, there is universal recognition of the need for reform. But drafting new rules for agricultural

trade requires an unprecedented political commitment by governments around the world since major changes in trade policies will not resolve the crisis without parallel changes in national farm programs that directly or indirectly affect exports and imports.

Just winning international agreement to make agricultural trade policies a priority subject in the Uruguay Round of multilateral trade negotiations was an uphill battle; in fact, the difficulty of achieving a consensus on this issue was one reason the launch of the eighth series of international trade talks under the auspices of the General Agreement on Tariffs and Trade was delayed until September 1986 (see JEI Report No. 22A, June 12, 1987). Convincing some of the world's big agricultural traders, notably the European Community, that domestic agricultural support programs also had to be put on the negotiating table in Geneva was even harder. But thanks in large part to constant prodding by the United States, Canada, Australia, New Zealand and a group of developing-country exporters led by Argentina, an international commitment to linked reforms has developed over the last year and a half.

The first break came at the April 1986 ministerial meeting of the Organization for Economic Cooperation and Development when representatives of the 24 industrial nations referred explicitly to the linkages between domestic and international market developments in agreeing to pursue agricultural trade reform. A month later at the Tokyo economic summit the leaders of the United States, Japan, West Germany, France, the United Kingdom, Italy and Canada endorsed the OECD statement. By the time GATT's 93 members met in Punta del Este, Uruguay to launch the new MTN round, the major agricultural trade players had conceded that domestic farm support programs were negotiable.

This was a crucial intermediate step in gaining an international commitment to comprehensive reform, and it was reflected in the straightforward language of the agriculture section of the Uruguay Round ministerial declaration: "Negotiations shall aim to achieve greater liberalization of trade in agriculture and bring all measures affecting import access and export competition under strengthened and more effective GATT rules and disciplines." But one stumbling block remained -- the world's key policymakers had still not acknowledged formally that national agricultural policies were responsible for the trade crisis. This obstacle was eliminated at the May 1987 OECD ministerial talks when the industrial nations agreed on the need to negotiate reductions in internal farm supports. With European leaders joining President Reagan, Canada's premier and Prime Minister Yasuhiro Nakasone in seconding this agreement at the Venice summit in June, the stage was set for the first multilateral trade negotiations on agriculture encompassing national support policies.

Anxious to keep the reform momentum going and at the same time put its stamp on the agenda of the GATT agriculture committee, the United States presented a sweeping proposal in early July -- a call for the complete phaseout of all policies that distort trade in agriculture by the year 2000. On Washington's elimination list are all export subsidies as well as any domestic program that directly or indirectly subsidizes agriculture, including price supports, income supports like deficiency payments and storage payments, and such other

policies as subsidized crop insurance and concessional farm credit. Also targeted for phaseout over the same 10-year period are all barriers to agricultural imports, whether tariffs, quotas, variable levies or minimum import price schemes. In fact, the only policies the White House proposes to leave in place are foreign and domestic food aid programs and direct income and other payments decoupled from production and marketing -- disaster relief, for example.

The free-trade thrust of Washington's historic proposal won strong support from Australia, Canada, New Zealand and their 10 developing-country partners in the Cairns group. In a plan presented to the GATT in late October Australia's prime minister echoed the U.S. call for the removal of all market barriers and trade-distortive subsidies by the end of the century, but he also addressed a major shortcoming of the initial American position -- the lack of measures to stabilize international markets over the short run. Filling in what in fact was a deliberate omission in the U.S. proposal, the Australian leader advocated an immediate freeze on export and production subsidies, a standstill on trade barriers and a multilateral commitment to dispose of surplus stocks in a non-disruptive way.

Emergency measures to stabilize the hardest-hit markets also provided the starting point for the proposal put forward by the Community at the end of October, although with one exception -- a call for reduced government support to farm sectors with big surpluses -- the steps outlined by the Europeans deal with the symptoms, not the causes, of the problems in agricultural trade. Far more troubling to negotiators for the United States and the Cairns group, though, is the EC position on phasing out subsidies and its unwillingness to set a timetable for reform. The Community is prepared to negotiate "significant" cuts in farm subsidies, its head of agriculture told the GATT meeting, but it cannot accept their complete elimination since such a move would knock the props out from under the EC's common agricultural policy.

Framing Japan's Proposal

While the United States, the Cairns group and the European Community argue about whose initial plan represents the most practical approach to agricultural trade reform, Tokyo is working out the details of its opening position for presentation to the GATT agriculture committee in December. This proposal will endorse the reform drive. But it is likely to diverge in important respects from the plans tabled by Japan's main trading partners because Japan approaches the negotiations from an entirely different standpoint -- that of an importer, the world's biggest net buyer of agricultural commodities, with imports topping exports by \$17.3 billion in 1986.

Tokyo's perspective on agricultural trade reform is also shaped by the fact that Japan, virtually alone among the major industrial nations, consumes more farm products on an aggregate basis than it produces. More important, its self-sufficiency in food and feed calculated on a supply/use basis has dropped from 90 percent 25 years ago to 71 percent (see Table 1) despite an increasing level of protection for Japanese farmers. The decline on a calorie basis is even steeper -- 53 percent now versus 79 percent at the start of the 1960s, making the contrast with the rising rates of self-sufficiency in the United States and Europe more dramatic.

Table 1: Food Self-Sufficiency Ratios in Japan, FY 1960-FY 1985

	<u>FY 1960</u>	<u>FY 1965</u>	<u>FY 1970</u>	<u>FY 1975</u>	<u>FY 1980</u>	<u>FY 1985</u>
Food and Feed Grains	82%	61%	45%	40%	33%	32%
Food Grains	89	80	74	69	69	69
Rice	102	95	106	110	87	107
Wheat	39	28	9	4	10	14
Beans and Peas	44	25	13	9	7	8
Soybeans	28	11	4	4	4	5
Other Vegetables	100	100	99	99	97	95
Fruits and Nuts	100	90	84	84	81	76
Eggs	101	100	97	97	98	98
Milk and Milk Products	89	86	89	85	86	89
Meat	91	90	89	76	81	81
Beef	96	95	90	69	72	72
Pork	96	100	98	86	87	86
Sugar	18	30	23	18	29	34
Overall Self-Sufficiency*	90	83	78	74	72	71

*Overall self-sufficiency ratio = $\frac{\text{Total value of domestic production}}{\text{Total value of domestic consumption}} \times 100$

This ratio as well as the figures for food and feed grains and food grains alone are based on the assumption that rice demand and supply are in balance. Using actual rice demand and supply numbers raises the overall ratio by two or three percentage points in years when there is excess production (FY 1985, for example) and lowers it by one to two points when there is a shortfall.

Source: Ministry of Agriculture, Forestry and Fisheries, Food Balance Sheet.

What really sets Japan's position apart, however, is the weight it assigns food security and other non-economic factors in the agricultural reform process. Insuring a stable supply of food through some minimum degree of self-sufficiency has been a fixture of Japanese farm policy for close to three decades. Neither the enormous expansion of world agricultural production and trade over this time nor the repeated arguments of exporters that Japan can and should meet its food and feed requirements through increased imports have fundamentally altered this objective. Memories of the severe food shortages during and after World War II are dimming, but they have been replaced by a series of more recent developments, including the 1972 U.S. soybean export restraints, the 1980 U.S. embargo on grain exports to the Soviet Union and this country's crop shortfalls in the early 1980s.

To achieve its goal of minimum self-sufficiency the government has maintained most domestic agricultural prices well above world levels through a combination of import restrictions and direct farm subsidy programs. The Ministry of Agriculture, Forestry and Fisheries' Food Agency controls the purchase and marketing of rice, wheat and barley, both domestically grown and imported, while the semi-governmental Livestock Industry Promotion Corp. directly handles the purchase and sale of most imported beef and a long list of dairy products; another government-affiliated corporation plays a similar role in the sugar market. Quantitative import restrictions are applied to 19 groups of farm

products (see Appendix A), in a number of cases to backstop state trading in food grains, beef, dairy products and sugar. Pork imports are subject to a variable levy, but Japan's poultry industry is protected only by relatively low tariffs. Moreover, corn, sorghum, soybeans, cotton, wool, tobacco and hides are imported with no or minimal intervention (see Table 2).

State trading of food grains is coupled with Food Agency support prices for rice, wheat and barley. Rice farmers who plant alternative crops also receive diversion payments, as do wheat and barley growers that made the switch from rice. Most direct government assistance for soybean farmers is in the form of deficiency payments. The same is true for dairy producers, although their payments come from the LIPC instead of MAFF's general account. For their part, beef and pork producers benefit from a price stabilization scheme operated by the LIPC, while growers of beet and cane sugar are guaranteed minimum prices by the same organization that stabilizes the prices of imported sugar. In addition, Japanese farmers, like their counterparts in the United States, receive indirect assistance from the government through such varied programs as insurance subsidies, land development, disaster relief, research and extension work. In fact, outlays for these programs are far greater than direct subsidy payments.

As it turns out, Tokyo's efforts to insure minimum self-sufficiency through import restrictions and budgetary support have been more of a boon for Japanese farmers than to the country's food security requirements. In studies prepared for the MTN agricultural trade talks, both the OECD and the U.S. Department of Agriculture concluded that Japanese producers are the most heavily assisted farmers in the industrialized world. The two organizations based this finding on a yardstick known as a producer subsidy equivalent (defined in broad terms as the subsidy level that would be needed to compensate producers for the elimination of government support), which, despite numerous drawbacks, is the only measure that captures the effects of import protection as well as budget outlays.

The OECD report, which covered 1979 through 1981, calculated that Tokyo's agricultural policy initiatives represented 59 percent of Japanese farm income -- almost four times the comparable number for the United States and more than a third higher than the EC level. Looking at the 1982-84 period, USDA found that government involvement in the agricultural sector had expanded in all developed countries but that Japan still headed the list with a government support-to-producer income ratio of 70, compared with 22 for the United States and 41 for the European Community.

At the same time the USDA study provided additional evidence that while Japanese agriculture as a sector is heavily subsidized, not all farmers need extensive government assistance to be competitive with imports. The support levels provided poultry and citrus producers, for example, were not out of line with what farmers received in other countries, in part because there are no price supports for these products. Beef, pork, soybean and sugar producers received intermediate levels of assistance. Skewing the overall Japanese figure was the high level of Tokyo's intervention in dairy products and food grains, especially rice, which accounts for 30 percent-plus of the country's agricultural output.

Table 2: Border Measures Affecting Selected Japanese Agricultural Imports

Commodity	1986 Imports*	Residual Quota**	Current Tariff	Other
Rice	\$4	No	0%	All purchases handled by MAFF's Food Agency.
Wheat	895	No	0	All purchases handled by MAFF's Food Agency.
Barley	149	No	0	All purchases handled by MAFF's Food Agency.
Corn (for formula feed)	1,177	No	0	
Corn (for processing)	499	No	--	Tariff quota, which totaled 3,097,400 metric tons in FY 1986. Imports within the quota are duty-free; imports above the quota subject to duty of ¥15,000 per metric ton.
Sorghum (for formula feed)	468	No	0	
Sorghum (for processing)	35	No	5	
Soybeans	1,088	No	0	
Raw Sugar	274	No	¥41,500 (per ton)	Variable levy applied when import prices are below minimum stabilization price for domestic sugar and rebates paid when import prices are above maximum stabilization price.
Cotton	811	No	0	
Wool	627	No	0	
Tobacco	397	No	0	
Cattle Hides and Skins	376	No	0	
Beef and Veal	554	Yes	25	Most imports handled by quasi-governmental Livestock Industry Promotion Corp.
Beef and Veal Tongue and Internal Organs	386	No	15	
Beef and Veal Offals	1	Yes	25	
Pork	1,037	No	0	Variable levy applied to keep import prices between floor and ceiling domestic stabilization prices.
Chicken	271	No	10 (bone-in legs) 14 (other)	
Oranges	98	Yes	20 (June-November) 40 (December-May)	
Lemons and Limes	101	No	5	
Grapefruit	128	No	12 (June-November) 25 (December-May)	

*Yen trade figures were converted into dollars using 1986's average annual exchange rate of ¥168.52.

**Excludes quotas administered in conjunction with state trading operations, notably those on food grains.

Although hard numbers are not available for the years since 1984, economists estimate that Japanese agricultural subsidization levels have continued to rise because of lower world commodity prices and the steep appreciation of the yen. This relationship highlights a key difference between government aid to the farm sector in this country and Japan. In Japan, as in the European Community, most assistance -- three-fourths according to USDA's calculations -- comes from import restrictions. The Japanese government's budget exposure is relatively limited, with Japanese consumers paying the tab for the wedge trade barriers have driven between domestic and world market prices.

Given the way Japan protects its farm sector, negotiators are certain to object strongly to Washington's proposal for agricultural trade reform since that plan would force Tokyo to replace current assistance programs with direct cash payments -- a prohibitive budget expense. Those objections should not be mistaken for intransigence, though. Japan not only has joined its trading partners in agreeing on the need to reduce domestic farm supports; it has taken the politically difficult first steps down this road, cutting the purchase price for rice this past summer (see below) after lowering support prices for wheat, barley, soybeans, milk and pork in 1986 (see Table 3).

There are signs that these cuts, unprecedented in the history of Japan's farm programs, will not be the last. But setting a specific timetable for reducing domestic subsidies as the Reagan administration has proposed is no more likely to be acceptable to Tokyo than it is to the European Community. The same goes for the U.S. proposal to eliminate all trade-distorting internal subsidies, which has been blasted by the Europeans (and, for that matter, many political analysts and agricultural economists in this country) as unrealistic and impractical.

Japan's expected refusal to phase out domestic support programs goes back to its position that there must be room in the agricultural reform process for food security and other non-economic policy considerations. This argument no doubt will be used also to justify the continued existence of some import restrictions. Which ones is not clear since Japanese trade policymakers have referred only to "special circumstances" in discussing the need for protection. At the same time this terminology suggests the likelihood of further import liberalization.

Pressures for Change

While Japan's proposal for reforming world agricultural trade will fall short of the free-trade plan advanced by the United States, the fact that Tokyo is prepared to negotiate on agriculture in the GATT represents a landmark shift in position. This turnabout is perhaps the most visible sign of the changes occurring in Japanese agricultural policies -- changes triggered by a combination of domestic and external developments and facilitated by the first public debate in Japan of farm policies, particularly the rice program.

Providing the backdrop for the debate was the government's renewed 1986 effort to bring rice production in line with declining domestic demand. With two consecutive bumper harvests and a third on the way, MAFF officials worried that Japan was headed toward another big inventory buildup just two years after Tokyo had completed an enormously expensive rice disposal program. Their solution -- a cut in the government purchase price -- was a radical one for a

Table 3: Agricultural Support Prices in Japan, 1983-87

		(in yen)				
<u>Commodity</u>	<u>Unit</u>	<u>1983</u>	<u>1984</u>	<u>1985</u>	<u>1986</u>	<u>1987</u>
Rice	60 kg					
Government Purchase Price		Y18,266	Y18,668	Y18,668	Y18,668	Y17,557
Government Selling Price		17,033	17,673	18,327	18,598	18,133
Wheat	60 kg					
Government Purchase Price		11,092	11,092	11,092	10,963	10,426
Government Selling Price		4,135	4,135	4,135	3,886	3,692
Barley	50 kg					
Government Purchase Price		8,366	8,366	8,366	8,229	7,793
Government Selling Price		2,912	2,912	2,912	2,766	2,628
Soybeans (standard price)	60 kg	17,210	17,210	17,210	16,925	n.a.
Milk for Processing (guaranteed price)	1 kg	90.07	90.07	90.07	87.57	82.75
Pork	1 kg					
Upper Stabilization Price		780	780	780	760	645
Lower Stabilization Price		600	600	600	540	455
Wagyu Beef	1 kg					
Upper Stabilization Price		1,820	1,820	1,820	1,820	1,780
Lower Stabilization Price		1,400	1,400	1,400	1,400	1,370
Dairy Beef	1 kg					
Upper Stabilization Price		1,455	1,455	1,455	1,420	1,325
Lower Stabilization Price		1,120	1,120	1,120	1,090	1,020

Note: Grain and soybean prices cover crop harvested in year indicated. Live-stock and milk support prices are on a fiscal year basis. Because of changes in the grading systems for wheat and barley in 1987, year-to-year comparisons are inexact.

Source: Ministry of Agriculture, Forestry and Fisheries, Abstract of Statistics on Agriculture, Forestry and Fisheries.

ministry that had always regarded annual hikes in the support price as a producer entitlement, but it went to the heart of the problem since these increases were the primary cause of chronic overproduction.

Equally important for a government attempting a politically risky move, the cut in the producer price was not an ad hoc policy response. Instead, it was based on the production cost parity formula used to determine annual rice purchase prices. Tokyo could also justify its move by pointing to the fact that the average farmer's income was roughly 30 percent higher than that of his urban blue-collar counterpart as the result of a 25-year-old government policy to maintain farm and nonfarm incomes at comparable levels.

Once word got out that MAFF was proposing a 6.6 percent reduction in the rice support price, the political arm of Japan's agricultural cooperative movement (Nokyo) went into action, putting heavy and well-publicized pressure on the big Diet bloc of Liberal Democratic Party members representing rural constituencies. This pressure worked -- at least in the short run -- as the LDP representatives first forced the government to back off from the 6.6 percent cut, then to abandon its fallback position of a 3.8 percent reduction, and finally to settle for a freeze. But Nokyo's lobbying tactics also produced an unusual backlash in Japan. Joining the media in criticizing the organization were normally complacent consumer groups, a number of government leaders including Prime Minister Nakasone and even some LDP Diet members, who recognized that the party's landslide victory in the July 1986 double elections was due in part to new support from urban voters.

Anxious not to encourage any closer examination of the nation's protective rice policies when all the production, stock and cost numbers were running against them, farm groups adopted a low profile as the time approached this year to set the producer rice price. This gave MAFF a relatively free hand to tackle the problems caused by an expected fourth straight record rice crop (see Table 4), an above-average drop in rice consumption (see Table 5) and an

Table 4: Agricultural Production in Japan, 1970-86

(in thousands of metric tons)

	1970	1975	1980	1982	1983	1984	1985	1986
Rice*	11,547	11,980	8,873	9,346	9,433	10,809	10,612	10,599
Wheat	474	241	583	742	695	741	874	876
Barley	572	221	385	389	379	396	378	344
Sweet Potatoes	2,564	1,418	1,317	1,384	1,379	1,400	1,527	1,507
White Potatoes	3,594	3,261	3,421	3,775	3,566	3,707	3,727	4,073
Onions	973	1,032	1,152	1,257	1,170	1,099	1,326	1,252
Radishes	2,778	2,545	2,690	2,709	2,548	2,631	2,544	2,655
Cabbage	3,177	3,030	3,161	3,263	3,075	3,163	3,067	3,179
Cucumbers	965	1,023	1,018	1,071	1,048	1,070	1,033	1,040
Soybeans	126	126	174	226	217	238	228	245
Mandarin Oranges	2,552	3,665	2,892	2,864	2,859	2,005	2,491	2,168
Summer Oranges	254	372	366	318	345	325	269	288
Other Citrus Fruit	105	218	337	416	440	395	442	n.a.
Apples	1,021	898	960	925	1,048	812	910	986
Pork**	734	1,040	1,475	1,428	1,429	1,424	1,532	1,552
Beef**	288	353	418	481	495	536	555	559
Broiler Meat***	n.a.	n.a.	n.a.	1,080	1,143	1,217	1,270	1,275
Eggs	1,734	1,788	2,002	2,057	2,086	2,130	2,152	2,225
Milk	4,761	4,961	6,504	6,747	7,042	7,138	7,380	7,457
Sugar Cane	681	1,973	2,095	2,256	2,526	2,553	2,638	n.a.
Sugar Beets	2,332	1,759	3,550	4,108	3,377	4,040	3,921	n.a.
Tobacco	150	166	141	139	137	136	116	106

*Milled.

**Carcass weight equivalent.

***Ready-to-cook weight.

Source: Ministry of Agriculture, Forestry and Fisheries, Abstract of Statistics on Agriculture, Forestry and Fisheries and Monthly Statistics.

Table 5: Per Capita Annual Food Consumption in Japan, FY 1970-FY 1985

(in kilograms)

	<u>FY 1970</u>	<u>FY 1975</u>	<u>FY 1980</u>	<u>FY 1985</u>
Cereals	128.2	121.5	112.9	107.9
Rice	95.1	88.0	78.9	74.6
Wheat	30.8	31.5	32.2	31.7
Potatoes and Sweet Potatoes	16.1	16.0	17.3	18.6
Starch	8.1	7.5	11.6	14.1
Beans and Peas	10.1	9.4	8.5	9.0
Other Vegetables	114.2	109.5	110.3	108.3
Fruits and Nuts	37.9	42.4	38.7	37.0
Meat	13.4	17.9	22.5	25.2
Beef and Veal	2.1	2.5	3.5	4.4
Pork	5.3	7.3	9.6	10.3
Chicken	3.7	5.3	7.7	9.2
Eggs	14.5	13.7	14.3	14.9
Milk and Milk Products	50.1	53.3	62.1	67.1
Fish and Shellfish	31.6	34.9	34.8	35.8
Sugar	26.9	25.1	23.3	21.0
Edible Oils	9.4	11.4	13.8	14.1

Source: Ministry of Agriculture, Forestry and Fisheries, Food Balance Sheet.

inventory level already higher than the government's guideline for adequate stocks. Its primary response was no longer novel but in deciding in July to cut the support price for 1987 crop rice by 5.95 percent, the ministry kept public attention focused on agricultural policy. This was after all the first reduction in 31 years in the politically sacred purchase price. Moreover, the low-key response of the agricultural lobby and its Diet supporters to this precedent-shattering move attracted comment.

The agricultural community was also surprisingly restrained about MAFF's decision to increase the rice acreage diverted to other uses from about 560,000 hectares last year to 770,000 hectares or 30 percent of Japan's paddy land in the FY 1987-FY 1989 period and at the same time freeze or cut diversion incentives. These moves were designed to keep a lid on rice production and make Japanese agriculture in general more efficient, but they also had another purpose: trimming the Food Agency's budget.

The food control account has already been cut by two-fifths since FY 1981, and it is expected to be down by another 10 percent or so in the year ending in March 1988. The action on diversion payments will be one factor. But a bigger cause will be the significant growth in the Food Agency's profits from imported wheat sales as a result of low world wheat prices and the strong yen. Also helping is an injection of surplus money from the semi-governmental organization that handles most beef sales.

Farm policy moved back into the headlines in late October when the government approved the first cut in 45 years in the price at which it resells

rice to wholesalers. While this step had been expected since the reduction in the support price was announced, the 2.5 percent decline is still significant. For starters, wholesale rice prices will be higher than support prices, a first. More important, the cut represents a change in MAFF's strategy for slowing the decline in rice consumption in the face of another inventory build-up. Rather than trying to prop up consumer rice purchases by limiting the growth in wheat consumption through an unfavorable wheat/rice price ratio, the ministry is taking a more direct approach. It has also introduced a new wrinkle: lower prices for unsold 1986 crop rice than for rice harvested this fall.

The cut in the resale price also served a broader public relations purpose in Japan since it narrowed, however symbolically, the gap between high domestic rice prices and world market prices. This difference had already been used by U.S. rice millers to document their September 1986 charge that Japan's rice policies are an unfair trade practice (see JEI Report No. 33B, September 12, 1986). With the gap expanding in dollar terms since then because of the yen's rise, Japanese consumers have had a constant reminder of the high price they pay for rice self-sufficiency.

Early Tests

The U.S. rice industry's attempt to turn Japan's rice policies into a high-profile bilateral issue was foiled by the White House (see JEI Report No. 40B, October 31, 1986), but under pressure from Washington, Tokyo has agreed to discuss rice during the Uruguay Round if other countries put all their agricultural programs on the negotiating table. This is certainly a significant concession, one that would not have been possible 18 months ago, even though the government has always maintained that its rice policies are GATT-compatible. Yet because of the unique role of rice in Japanese agriculture, this concession does not provide a good indication of how flexible the government might be in the MTN on the overall issue of import liberalization.

Japan's trading partners should soon get an early reading, however. Over the next few weeks Tokyo must decide how it will respond to an upcoming GATT ruling that the quantitative import limits on 12 groups of processed agricultural commodities and food products are illegal. (See Appendix A for a description of the 12 groups.) In ongoing discussions with the United States, which initiated the Article 23 proceeding in mid-1986 (see JEI Report No. 27B, July 25, 1986, and No. 19B, May 15, 1987), Japanese trade negotiators have reportedly offered to lift the restraints on some categories. But they say the government's hands are tied on others because the quotas are an integral part of state trading operations.

Another test of Japan's flexibility on agricultural trade reform is also coming up since the 1984 arrangement expanding beef and citrus imports expires next March (see Table 6 and Appendix B). Tokyo has not given any hints of how it will respond to Washington's demand for immediate liberalization of fresh, chilled and frozen beef, fresh oranges and orange juice, but many analysts believe the government will agree to free oranges without too much argument. Pointing to the fact that mandarins are consistently cheaper than imported oranges except during the off-season, they say domestic growers could compete in an open market without a support program. Beef is another matter. Quota increases would be manageable, but free trade would require extensive government assistance to the industry.

Table 6: Japan's Beef and Citrus Quotas, FY 1983-FY 1987

(in metric tons)

<u>Fiscal Year</u>	<u>Beef</u>			<u>Oranges</u>			<u>Concentrate Juice</u>	
	<u>First Half</u>	<u>Second Half</u>	<u>Total</u>	<u>Annual</u>	<u>Off- Season</u>	<u>Total</u>	<u>Orange</u>	<u>Grapefruit</u>
1983	72,000	69,000	141,000	36,500	45,500	82,000	6,500	6,000
1984	76,000	74,000	150,000	44,750	48,250	93,000	7,000	--
1985	80,000	79,000	159,000	53,000	51,000	104,000	12,500	--
1986	85,000	83,000	168,000	n.a.	n.a.	115,000	8,000	--
1987	93,000	121,000	214,000	n.a.	n.a.	126,000	8,500	--

Notes

1. Beef - Includes the general quota (194,000 metric tons in FY 1987) as well as the smaller quotas for hotels (4,000 metric tons), Okinawa (6,250 metric tons), school lunches (1,750 metric tons), boiled beef (6,000 metric tons) and demand development (2,000 metric tons). Also includes imports of high-quality beef, for which there is no separate quota.
2. Oranges - The annual quota covers imports at any time during the year, while the off-season quota is restricted to the June-August period.
3. Orange juice - Imported juice must be blended with domestic mandarin juice. The jump in the FY 1985 quota reflects an extra 5,000-metric-ton allocation to free domestic output for processing in the wake of a reduced 1984 harvest.
4. Grapefruit juice - Imports were decontrolled at the start of FY 1986. In FY 1984 and FY 1985 import licenses were issued to supply demand.

For further information, contact Susan MacKnight.

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The views expressed in this report are those of the author and do not necessarily represent those of the Japan Economic Institute.

JEI Report will not be published on November 27 because of the Thanksgiving holiday. The next issue will appear on December 4, 1987.

APPENDIX A - Japan's Residual Import Quotas

<u>CCCN Number</u>	<u>Description</u>
1. 02.01-1 ex	Beef and veal, fresh, chilled or frozen, and offals, except tongue and internal organs
2. 03.01-2-(2) ex	Herring, cod (including Alaska pollack) and its roes, yellowtail, mackerel, sardines, horse mackerel and saurel, fresh, chilled or frozen
3. 03.02-1 ex	Hard roes of cod (including Alaska pollack), dried, salted or smoked
03.02-2-(1) ex	Cod (including Alaska pollack), herring, yellowtail, mackerel, sardines, horse mackerel, saurel and <u>niboshi</u> , dried or salted
4. 03.03-2-(1) ex	Scallops, adductors of shellfish, cuttlefish and squid (other than Mongo ika), fresh, chilled or frozen
03.03-2-(2) ex	Scallops, adductors of shellfish, cuttlefish and squid (other than Mongo ika), dried or salted
5. 04.01 ex	Sterilized or frozen milk and cream and other cream with a fat content of 13 percent or more, fresh, not concentrated or sweetened
*6. 04.02	Milk and cream, preserved, concentrated or sweetened
*7. 04.04-1	Processed cheese
04.04-2 ex	Other cheese (except natural cheese) and curd
*8. 07.05-1	Small red beans, dried and shelled
07.05-2 ex	Broad beans, horse beans and peas, dried and shelled, except seed
07.05-4 ex	Other beans, dried and shelled, except green beans and seed
9. 08.02-2 ex	Oranges, fresh
08.02-4 ex	Tangerines, fresh
10. 08.11-2 ex	Oranges, provisionally preserved by sulfur dioxide gas or other preservative gases
08.11-3 ex	Tangerines, provisionally preserved by sulfur dioxide gas or other preservative gases
11. 11.01-1	Wheat flour
11.01-2 ex	Rice flour and barley flour
12. 11.02-1 ex	Groats, meal and similar preparations (except germ) of wheat and rice
11.02-2 ex	Groats, meal and pellets or barley
*13. 11.08	Starches and insulin
*14. 12.01-2 ex	Peanuts, except for oil extraction
15. 12.08-3-(1)	Edible seaweed, wet or dried, formed into rectangular papery sheets not more than 430 square centimeters each

12.08-3-(2)	Other edible seaweed of specified genera
12.08-3-(3) ex	Other edible seaweed of specified genera
12.08-4	Tubers of Konnyaku (devil's tongue), whether or not cut, dried or powdered
*16. 16.02-2 ex	Other prepared or preserved products consisting wholly or chiefly of beef or pork, except ham and bacon
*17. 17.02-1-(2)	Glucose, not containing added sugar or flavoring and coloring material
17.02-3-(2) ex	Lactose, not containing added sugar or flavoring and coloring material, less than 90 percent milk sugar by weight
17.02-5	Sugar syrup, except maple sugar
17.02-6	Caramel
17.02-7	Artificial honey
17.02-8-(1/2)-B	Other sugars and syrups, except sorbose and hi-test molasses
*18. 20.05 ex	Fruit purees and fruit pastes made from citrus fruits (except lemons and limes), pineapples, grapes, apples or peaches
*19. 20.06-1-(1)	Pineapples, otherwise prepared or preserved, containing added sugar
20.06-1-(2) ex	Fruit pulp made from citrus fruits (except lemons and limes), grapes, apples or peaches
20.06-2-(1)	Pineapples, otherwise prepared or preserved, not containing added sugar
20.06-2-(2) ex	Fruit pulp made from citrus fruits (except lemons and limes), grapes, apples or peaches, not containing added sugar
*20. 20.07 ex	Fruit juices except made from lemons, limes, grapefruit, cherries, apricots, berries (excluding blueberries and strawberries), prunes, mangos and other tropical fruits (excluding pineapples) and sloe bases
20.07-2 ex	Tomato juices with a dry weight content less than 7 percent
*21. 21.04-1-(1)	Tomato ketchup and tomato sauce
*21. 21.07-2 ex	Ice cream powder, prepared milk powder for infants and other preparations consisting mainly of milk; seaweed preparations; <u>mochi</u> , cooked rice, roast rice flour, <u>mijinco</u> , <u>kanbaiko</u> , vitamin-enriched rice and similar preparations of rice, wheat and barley; and other food preparations (except rations, peanut butter, sweet corn, Korean ginseng tea and those with less than a 50 percent sugar content)

Note: Starred items represent the 12 groups of products included in the U.S.-initiated GATT complaint. An "ex" after a CCCN number indicates that only the specified items are subject to quota; other goods coming in under that tariff number are liberalized. If no "ex" appears, all items falling within the CCCN number are under quota.

APPENDIX B

Table 1: Japan's Major Agricultural Imports, 1984-86

	Quantity (in metric tons)			Value (in thousands of dollars)		
	1984	1985	1986	1984	1985	1986
Total	---	---	---	\$18,557,595	\$16,883,621	\$18,433,836
Beef and Veal*	145,559	150,579	179,104	454,703	464,513	554,011
Beef and Veal Offals*	65,294	74,752	88,685	194,009	276,268	386,955
Lamb and Mutton*	74,702	79,470	79,300	121,396	112,011	111,180
Pork*	195,611	190,221	207,719	708,871	694,999	1,037,421
Chicken*	103,726	100,455	174,429	166,939	142,443	270,594
Powdered Skim Milk	90,291	104,261	90,970	66,087	75,970	68,431
Cheese	79,170	81,639	81,208	124,246	125,069	134,245
Wheat	5,978,324	5,509,614	5,619,640	1,112,744	983,202	894,778
Barley	1,566,801	1,660,947	1,362,716	237,896	219,250	148,628
Corn	14,169,620	14,225,106	14,653,155	2,301,861	1,922,680	1,675,242
Grain Sorghum	4,477,957	4,792,798	4,976,180	654,808	576,578	502,812
Malt	539,645	432,484	478,608	195,475	137,532	145,787
Oranges	89,121	111,635	117,300	82,444	91,360	98,105
Lemons and Limes	122,639	113,924	125,825	91,302	100,885	100,522
Grapefruit	157,887	120,804	182,431	89,647	78,729	128,012
Bananas	682,355	680,035	764,565	256,050	302,377	378,614
Fruit Juices**	16,911	35,104	29,936	35,643	81,760	61,415
Frozen Vegetables	155,159	155,100	185,194	141,874	138,404	122,080
Canned Vegetables	99,280	90,266	105,537	63,110	59,441	56,130
Sugar	1,842,557	1,924,144	1,819,358	293,466	208,942	276,365
Molasses	785,634	785,487	596,163	66,676	56,754	59,690
Coffee	239,443	247,567	263,783	768,171	751,761	1,137,610
Cocos	50,702	52,237	55,974	148,514	154,984	157,198
Peanuts	62,877	57,223	56,526	71,931	54,662	51,715
Soybeans	4,515,183	4,909,505	4,817,220	1,440,093	1,216,727	1,088,268
Rapeseed	1,298,802	1,468,617	1,439,943	412,398	440,161	304,492
Palm Oil	156,574	161,292	196,039	114,496	93,984	64,463
Wine**	48,903	45,293	33,656	68,046	72,835	76,111
Whiskey**	51,358	38,797	43,804	125,953	103,339	147,308
Brandy**	12,400	12,490	14,077	63,700	69,615	96,937
Tobacco	75,174	60,563	67,781	426,002	366,920	397,377
Cigarettes***	6,949,599	7,648,246	11,790,759	103,090	106,380	183,901
Natural Rubber	497,522	523,124	518,610	500,589	410,539	417,535
Cotton****	707,973	680,967	694,979	1,298,295	1,039,511	811,091
Wool	201,371	208,465	191,580	671,080	679,039	627,273
Samie	15,801	12,492	16,237	54,261	50,507	73,932
Cattle Hides and Skins	219,230	204,484	198,717	393,811	315,444	375,629

*Fresh, chilled or frozen.

***Quantity in thousands.

**Quantity in thousands of liters.

****Excludes lintners.

Note: The following average annual exchange rates were used to convert the yen trade figures: 1984, Y237.52; 1985, Y238.54; and 1986, Y168.52.

Table 2: Japan's Imports of Corn, 1982-86

	(in metric tons)				
	1982	1983	1984	1985	1986
Total	13,570,851	14,700,900	14,169,620	14,225,106	14,653,155
United States	10,956,001	13,438,302	13,736,803	10,969,579	9,244,260
China	0	0	210,469	2,577,801	2,689,018
South Africa	2,398,484	1,030,419	9,674	78,033	1,279,896
Argentina	120	29,808	118,123	466,295	1,276,380
Feed Corn	10,316,152	11,010,917	10,273,531	10,203,184	10,391,635
United States	9,945,181	10,978,795	9,967,746	8,310,119	7,538,896
China	0	0	165,221	1,388,557	1,486,779
Argentina	0	28,778	86,199	410,689	1,190,881
Corn for Industrial Use	3,254,699	3,689,983	3,896,089	4,021,922	4,261,520
United States	1,010,820	2,459,507	3,769,057	2,659,460	1,705,364
China	0	0	45,428	1,189,294	1,202,239
South Africa	2,228,717	1,027,525	9,674	78,033	1,198,507

Table 3: Japan's Imports of Grain Sorghum, 1982-86

	(in metric tons)				
	<u>1982</u>	<u>1983</u>	<u>1984</u>	<u>1985</u>	<u>1986</u>
Total	3,427,768	2,956,832	4,477,957	4,792,798	4,976,180
United States	2,180,117	656,076	1,860,473	2,571,415	2,079,090
Argentina	834,971	2,189,277	1,613,045	1,265,705	1,577,941
Australia	409,699	103,290	1,000,212	792,826	747,959

Table 4: Japan's Imports of Soybeans, 1982-86

	(in metric tons)				
	<u>1982</u>	<u>1983</u>	<u>1984</u>	<u>1985</u>	<u>1986</u>
Total	4,343,861	4,994,883	4,515,183	4,909,505	4,817,220
United States	4,196,406	4,646,134	4,180,630	4,345,350	4,331,621
China	111,912	287,971	307,863	288,572	323,136
Brazil	0	23,865	0	220,922	128,089

Table 5: Japan's Imports of Wheat, 1982-86

	(in metric tons)				
	<u>1982</u>	<u>1983</u>	<u>1984</u>	<u>1985</u>	<u>1986</u>
Total	5,713,299	5,816,329	5,978,324	5,509,614	5,619,640
United States	3,417,255	3,347,809	3,432,904	3,231,741	3,241,279
Canada	1,308,694	1,485,708	1,484,726	1,234,201	1,376,860
Australia	987,350	982,812	1,060,694	1,043,672	1,001,501
Wheat for Food Use	4,419,111	4,549,127	4,708,290	4,326,330	4,584,096
United States	2,786,293	2,735,782	2,816,800	2,719,568	2,801,482
Canada	1,308,694	1,485,708	1,484,726	1,234,201	1,375,600
Australia	324,124	327,637	406,764	372,561	407,014
Wheat for Feed Use	1,294,188	1,267,202	1,270,034	1,183,284	1,035,544
United States	630,962	612,027	616,104	512,173	439,797
Australia	663,226	655,175	653,930	671,111	594,487

Table 6: Japan's Imports of Cotton, 1982-86

	(in metric tons)				
	<u>1982</u>	<u>1983</u>	<u>1984</u>	<u>1985</u>	<u>1986</u>
Total	784,134	666,281	707,973	680,967	694,979
United States	353,274	315,905	372,174	275,611	200,819
Australia	80,767	45,265	60,585	91,426	101,516
China	8	5,583	23,886	75,240	99,113
Pakistan	35,464	45,690	14,736	75,221	99,015
U.S.S.R.	91,574	42,974	37,981	16,475	46,033
Nicaragua	26,315	43,320	50,569	37,464	26,017
Egypt	30,558	29,571	30,235	28,172	25,857
India	6,616	10,993	11,076	7,160	23,260
Mexico	41,439	28,356	37,673	19,065	21,664

Table 7: Japan's Imports of Tobacco, 1982-86

	(in metric tons)				
	<u>1982</u>	<u>1983</u>	<u>1984</u>	<u>1985</u>	<u>1986</u>
Total	83,466	80,062	75,175	60,564	67,781
United States	49,810	51,706	45,772	38,748	43,905
Turkey	5,716	5,357	5,262	4,773	5,077
Greece	5,974	4,684	6,922	2,881	3,903
Malawi	2,639	2,929	3,243	2,685	3,525

Table 8: Japan's Imports of Fresh, Chilled or Frozen Beef and Veal, 1982-86

	(in metric tons)				
	<u>1982</u>	<u>1983</u>	<u>1984</u>	<u>1985</u>	<u>1986</u>
Total	122,079	137,426	145,559	150,579	179,104
Australia	85,997	90,952	91,842	92,936	105,167
United States	31,570	37,711	42,238	46,514	63,389

Table 9: Japan's Imports of Fresh, Chilled or Frozen Beef and Veal Offals, 1982-86

	(in metric tons)				
	<u>1982</u>	<u>1983</u>	<u>1984</u>	<u>1985</u>	<u>1986</u>
Total	56,393	61,953	65,294	74,752	88,685
United States	44,166	50,745	54,540	61,153	74,355
Australia	6,716	5,884	5,529	6,156	7,152

Table 10: Japan's Imports of Fresh, Chilled or Frozen Pork, 1982-86

	(in metric tons)				
	<u>1982</u>	<u>1983</u>	<u>1984</u>	<u>1985</u>	<u>1986</u>
Total	141,086	166,253	195,611	190,221	207,719
Taiwan	19,688	33,084	50,721	67,822	83,880
Denmark	18,905	17,680	75,098	77,449	78,111
Canada	43,570	41,836	29,581	21,947	22,437
United States	32,755	35,410	22,931	11,906	14,731

Table 11: Japan's Imports of Fresh, Chilled or Frozen Chicken, 1982-86

	(in metric tons)				
	<u>1982</u>	<u>1983</u>	<u>1984</u>	<u>1985</u>	<u>1986</u>
Total	102,927	100,575	103,726	100,455	174,429
United States	55,328	64,121	50,827	46,567	75,472
Thailand	32,645	21,353	29,969	35,308	63,598

Table 12: Japan's Imports of Fresh Oranges, Lemons and Limes and Grapefruit, 1982-86

	(in metric tons)				
	1982	1983	1984	1985	1986
Oranges	82,421	89,191	89,121	111,635	117,300
United States	82,284	89,048	88,465	110,462	115,968
Lemons and Limes	104,601	119,555	122,639	113,924	125,825
United States	103,641	118,158	121,200	111,901	124,912
Grapefruit	153,704	177,289	157,887	120,804	182,431
United States	140,541	166,635	149,884	111,996	176,771

Source for Tables 1-12: Ministry of Finance, Japan Exports and Imports: Commodity by Country.Table 13: Major U.S. Agricultural Exports to Japan, 1984-86

	Quantity (in metric tons)			Value (in thousands of dollars)		
	1984	1985	1986	1984	1985	1986
Total	---	---	---	\$6,782,301	\$5,409,105	\$5,106,464
Corn*	13,641,997	10,977,346	9,169,571	1,990,200	1,292,583	866,037
Grain Sorghum*	2,232,603	2,425,873	2,144,704	269,095	240,862	177,271
Soybeans*	4,235,897	4,375,137	4,224,932	1,197,534	951,680	856,091
Alfalfa Meal and Cubes	427,576	400,494	550,806	60,275	56,812	78,570
Dried Beet Pulp	403,187	326,175	412,657	58,185	43,871	55,111
Wheat	3,377,081	3,120,324	3,224,286	534,445	468,970	424,330
Barley	360,662	138,195	49,208	46,718	14,179	4,300
Beef and Veal**	77,640	82,580	110,978	322,206	350,627	470,667
Beef and Veal Offals**	34,538	36,408	48,097	76,941	76,138	119,378
Pork**	18,908	9,183	11,952	62,138	32,654	52,267
Chicken**	50,823	45,019	75,887	72,085	55,144	88,635
Eggs	---	---	---	9,327	17,530	35,213
Lemons and Limes	120,130	109,761	122,793	80,447	77,146	83,008
Grapefruit	144,713	107,686	156,199	51,362	51,506	74,125
Oranges	87,286	108,127	112,151	61,977	73,317	68,485
Raisins	16,686	20,263	20,816	18,412	21,969	24,069
Frozen Vegetables	83,531	86,822	121,224	59,525	60,958	84,167
Canned Vegetables	18,423	19,830	29,290	16,947	16,056	23,149
Almonds	14,816	17,020	24,698	48,268	45,342	89,693
Vegetable Oils	41,613	42,816	47,039	37,136	37,113	39,054
Chocolate Products	3,883	1,792	4,501	13,889	9,500	21,942
Cotton***	363,381	244,110	182,886	605,078	368,042	238,621
Tobacco	41,782	46,269	36,956	285,979	302,387	227,115
Whole Cattle Hides****	7,333,641	6,824,464	6,624,385	305,022	276,077	301,974
Seeds	32,809	26,814	29,667	38,382	38,972	36,206

*Excludes seed.

***Excludes linters.

**Fresh, chilled or frozen.

****Quantity in number of pieces.

Source: Department of Agriculture, Foreign Agricultural Trade of the United States.

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Financial Market Restructuring

Despite the sharp decline in equity markets around the world and the ensuing volatility of exchange and interest rates, the Ministry of Finance will continue to push ahead as planned with financial market liberalization and deregulation. In fact, the recent volatility and the relative ease with which domestic financial institutions weathered the storm is being cited as evidence that Japanese companies are fundamentally sound and that MOF can proceed without undue concern. With deregulation of interest rates well under way, the ministry's focus is shifting to structural reform of the financial sector.

The following developments have taken place or are under discussion:

- Instruments with market-determined interest rates - MOF is continuing its efforts to put financial instruments with unregulated interest rates

- Insider trading rules - On October 19 MOF's Securities and Exchange Council established a special panel to regulate insider trading and other fraudulent securities transactions. The panel's first order of business was to propose new legislation to strengthen the government's powers to monitor and punish unethical trading practices. MOF's actions come on the heels of the Tateho Chemical Co., Ltd.'s bond futures trading scandal that rocked markets in September and October. It was determined that company and brokerage officials with inside information about Tateho's huge bond trading losses sold large blocks of Tateho stock before the information was made public. Nevertheless, no charges were filed.

- Foreign participation in government bond sales - After some delays due to chaotic market conditions, the Finance Ministry held its first auction of 10-year bonds November 12, awarding foreign firms 16.6 percent of the Y140 billion (\$1 billion) offering. Combined with the sale of the remaining Y560 billion (\$4 billion) worth of 10-year bonds through the traditional bond syndicate, foreign firms won a total of 4.6 percent of the Y700 billion (\$5 billion) sale, well above their 1.6 percent share of the previous bond sale. According to press reports six foreign firms bid for the maximum Y7 billion (\$50 million) worth of bonds allowed to any one firm under the auction system. Since all bids totaled over Y330 billion (\$2.4 billion), MOF scaled back the maximum allotments to just under Y3 billion (\$21 million).

MOF is currently grappling with the issue of reforming Article 65 -- the Japanese equivalent of the Glass-Steagall Act -- to allow banks and securities companies to compete directly against each other. Although progress in Congress toward repealing the U.S. law appears stalled by recent stock market gyrations, MOF seems to be moving ahead cautiously. Its approach is to allow banks and securities companies to compete directly through arms-length subsidiaries on a limited, experimental basis. In addition, the government would break down the traditional distinctions between banks before taking down the barriers between banks and securities firms. MOF's decision to allow foreign banks to co-own Japanese securities operations and to allow IBJ's Schroder unit to bid for a TSE seat is evidence that the first step has been accomplished. MOF is now beginning the second phase of reshaping the banking industry by forcing the 69 mutual savings (sogo) banks (which traditionally focused on small business loans), three long-term credit banks, 13 nationwide commercial banks and the Bank of Tokyo to shift and consolidate operations. Once the restructuring is complete and assuming the bank/securities company experiments are successful, MOF will move on Article 65. It will take some time to reach this stage, however, and officials are not likely to change their incremental approach even if the United States repeals Glass-Steagall.

Jon Choy

Japan's Monetary Expansion Continues

The Bank of Japan released preliminary figures November 9 that indicate the money supply continues to grow rapidly. The most widely watched measure of money, M2+CDs, grew 11.1 percent in September compared to the same period a year earlier. For the July-September quarter, preliminary figures indicate a 10.8 percent year-to-year change. Both figures are higher than previous periods.

Changes in Japan's Money Supply

(percentage change from year-earlier figures)

	<u>M2+CDs</u>
FY 1986	8.6%
1987 April	9.8
May	10.2
June	10.0
July	10.3
August	11.0
September	11.1

As the table shows, however, the money supply has been growing rapidly for some time. Much of the increase has gone toward the purchase of assets such as land rather than for current production, and therefore has not had the stimulus effect that might be expected. Real estate loans accounted for about 29 percent of the increase in M2+CDs in fiscal 1986. This partly explains why land prices, particularly in the big cities, have risen rapidly even while the overall rate of inflation at the wholesale and consumer level has been remarkably low.

There are a few signs, though, that inflation might begin picking up. Capacity utilization has been rising, commodity prices are starting to increase and some shortages are showing up. Wholesale domestic prices, which fell 2.4 percent in the October-December 1986 period from the previous quarter, dropped again by 0.6 percent in the first quarter of this year. They were unchanged in the April-June quarter but increased 0.9 percent in the quarter ending in September. October's prices were unchanged from September's.

Until mid-October policymakers were allowing interest rates to creep up, but the stock market crash in the United States and elsewhere would appear to reduce the options available. For one thing the more or less simultaneous stock market declines around the world heightened the sense that national economies are linked. Even more than usual, Japan now has to take U.S. policy into account in formulating its position.

In the United States the Federal Reserve Board was clearly moving toward a more restrictive policy prior to the crash in order to head off inflation. The crash was a clear signal to change course and the Fed immediately loosened monetary policy, choosing to gamble with the possibility of inflation. Washington's decisions reflect an increasingly political context as the president enters his last year in office. Economic decisions made now will determine to a substantial degree the environment on election day.

The Japanese find themselves at a different point in the political cycle. The new Japanese government might be expected to take a longer view if only because it is new and does not face an election that would reflect on its economic policy. A longer view in this case would probably persuade political leaders to put more emphasis on fighting inflation than on preventing a downturn in the economy.

In short, Japanese monetary policy is at something of a crossroads. If rapid money growth continues there is a perceived risk of inflation. If money growth slows too much, Japanese interest rates could rise and economic growth could slow. The current account could then stop shrinking, with negative consequences for relations with the United States.

Douglas Ostrom

Japan-EC Relations Looking Up

Relations between Japan and the European Community continue to fluctuate, although the tensions common to U.S.-Japan relations are generally absent. One reason for this is that bilateral trade represents a relatively small portion of each side's overall trade. Another is that EC exports to Japan have been growing at a faster rate than imports from Japan during the past several months. Nevertheless, Japan and the EC find themselves at odds over a wide range of issues while at the same time finding common ground on others.

The bilateral debate over Japan's alcoholic beverage taxes seems to be at a key point. The EC has long complained that the Japanese tax system hampers foreign suppliers of wines and spirits. Last February the General Agreement on Tariffs and Trade began an investigation under Article 3 (nondiscriminatory taxation) at the EC's request. On November 10 the GATT asked Japan to revise its liquor tax system to end discrimination against foreign products. The council pointed to four areas to be reformed: the whiskey and brandy grading system; the structure of the ad valorem tax on wine, spirits and liqueurs; higher taxes on foreign liqueurs than on domestic products; and the low tax on shochu, a domestic liquor. The council rejected an EC argument that Japan's beverage labeling laws also violated Article 6 of the GATT code, which calls on members to prevent misunderstandings on the origins of products.

The Ministry of Finance had actually proposed many of these reforms as part of a fiscal 1987 tax package (see JEI Report No. 20A, May 22, 1987). Due to a Diet impasse over other parts of the tax bill, however, the proposed adjustments never came to a vote. After the GATT ruling MOF said it would try to obtain quick passage of a reform bill by submitting it separately from the controversial tax package. Willy De Clercq, EC commissioner in charge of external affairs, welcomed both the GATT decision and MOF's plans, and said he hoped that liquor exporters would take advantage of any changes.

Japan and the Community are also on opposite sides at the GATT on several other issues. The EC wants the GATT to pressure Japan to drop its controls on semiconductor prices that it agreed to under the 1986 U.S.-Japan semiconductor accord. A panel was convened in April to decide whether Tokyo's actions violate GATT Articles 1 (the most favored nation clause), 6 (the anti-dumping and countervailing-duty clause) and 11 (the abolition of quantitative restrictions). While Washington is satisfied that the pact is yielding dividends, the EC continues to rail against it as trade-distorting and harmful to EC economic interests. Tokyo's position is that the EC has not been discriminated against under the agreement and that the provisions to monitor chip prices in third-country markets do not contravene GATT rules. The GATT panel is continuing its investigation with testimony from chip-importing nations such as Singapore.

The EC's decision to strengthen antidumping rules to include parts and subassemblies of items such as photocopiers and videocassette recorders continues to irk Japanese industry. Japanese corporations have been setting up assembly plants on the continent in an effort to contribute to the local economy and avoid EC import controls. After European companies complained that these transplants were only "screwdriver" factories, the EC decided to take a harsher stance. Japan is still considering taking the issue before the GATT but hopes that a negotiated settlement can be found.

Forming a backdrop to these disputes are bilateral trade statistics showing healthy growth. The growth rate disparity between Japan's imports from and exports to the Community is surprisingly large. For example, September's dollar-based imports rose 19.3 percent while exports grew less than half this at 8.6 percent. Nevertheless, the bilateral trade imbalance has widened during the first nine months of 1987 from \$13.3 billion in 1986 to \$15.3 billion because Japan's exports to the EC are more than double imports.

Although some trade issues remain sensitive, such as European disappointment that Tokyo did not allocate any of its emergency buying package for European aircraft (see JEI Report No. 41B, October 30, 1987), both sides consider relations to be on the upswing.

Jon Choy

Update On Japan-Latin America Relations

Tokyo's plan to recycle \$20 billion of its current account surplus to the developing countries (see JEI Report No. 21B, June 5, 1987) has given a prominence to Latin American countries heretofore unparalleled in Japan's foreign policy. The recycling initiative, which is designed to assist major debtor nations (primarily in Latin America and Asia), has catapulted Latin America to a position of greater importance to the government.

Until relatively recently Latin American countries held a minor role in Japan's foreign policy considerations, largely because the region's proximity to the United States seemed to make it Washington's responsibility. Several factors have combined to elevate Latin America's importance to Tokyo, however, including its one million Japanese residents (mainly in Brazil, Paraguay, Peru and Mexico), rich supply of natural resources, and the increasing pressure on Tokyo to expand its foreign aid flows to non-Asian areas.

Partly as a result of these factors, Japan's economic presence in Latin America has been steadily expanding. Exports have skyrocketed by 89 percent since 1976 (in dollar terms), while imports have jumped by over 150 percent (see Table). As with many other developing countries, the overwhelming majority of exports consists of machinery and other industrial goods, while imports are primarily agricultural and industrial raw materials.

While the appreciation of the yen has made investment opportunities less expensive, government officials are pessimistic about the likelihood of significant increases in the near future. Japan's private sector cites high inflation rates in the region, political instability (including the threat of nationalization), and economic crises as disincentives to investment. Indeed, more than half of Japanese ventures consist of "paper investments," such as Panamanian ship registrations.

Japan's Trade with Latin America: 1966, 1976, 1984-86

(in millions of dollars, exports f.o.b./imports c.i.f.)

	<u>1966</u>	<u>1976</u>	<u>1984</u>	<u>1985</u>	<u>1986</u>
Colombia					
Exports	\$23.7	\$162.8	\$403.6	\$422.1	\$385.9
Imports	8.4	60.7	152.2	150.4	267.1
Trade Balance	15.3	102.1	251.4	271.7	118.8
Mexico					
Exports	50.2	385.9	887.9	994.0	1,032.0
Imports	177.7	248.2	2,259.8	1,869.9	1,439.0
Trade Balance	-127.5	137.7	-1,371.9	-875.9	-407.0
Panama					
Exports	63.5	1,304.5	3,444.0	3,326.1	3,196.8
Imports	8.7	35.5	167.9	81.3	83.7
Trade Balance	54.8	1269.0	3,276.1	3,244.8	3,113.1
Cuba					
Exports	6.5	199.5	250.3	300.9	292.7
Imports	22.2	50.3	78.0	92.3	131.1
Trade Balance	-15.7	149.2	172.3	208.6	161.6
Venezuela					
Exports	62.6	562.8	347.7	352.1	516.0
Imports	25.0	33.5	467.3	367.7	335.3
Trade Balance	37.6	529.3	-119.6	-15.6	180.7
Peru					
Exports	57.0	143.9	160.1	140.6	224.3
Imports	124.1	232.1	407.3	331.9	326.0
Trade Balance	-67.1	-88.2	-247.2	-191.3	-101.7
Chile					
Exports	23.1	77.2	290.9	168.6	294.4
Imports	149.4	298.3	634.7	533.7	534.6
Trade Balance	-126.3	-221.1	-343.8	-365.1	-240.2
Brazil					
Exports	44.0	881.6	639.5	614.9	973.1
Imports	60.6	818.6	1,990.8	1,840.2	1,874.6
Trade Balance	-16.6	63.0	-1351.3	-1225.3	-901.5
Argentina					
Exports	30.6	232.7	391.7	225.4	361.0
Imports	53.3	253.2	489.1	443.0	503.3
Trade Balance	-22.7	-20.5	-97.4	-217.6	-142.3
Other					
Exports	195.2	1,061.7	1,732.9	1,941.1	2,218.3
Imports	151.6	434.4	583.2	531.8	698.9
Trade Balance	43.6	627.3	1149.7	1409.3	1519.4
Total					
Exports	556.4	5,012.6	8,548.6	8,485.8	9,494.5
Imports	781.0	2,464.8	7,230.3	6,242.2	6,193.6
Trade Balance	-224.6	2,547.8	1,318.3	2,243.6	3300.9

Source: Japan Tariff Association, The Summary Report: Trade of Japan

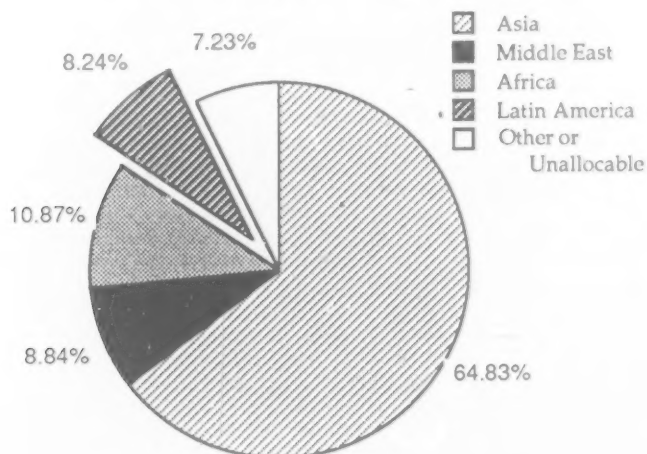
Still, Tokyo continues to stress the development of free market conditions and transfers of technology to promote economic stability in the region. To this end the government has set in place various programs to insure companies against non-commercial risks and to facilitate debt-equity swaps in the region. Investors remain reluctant to make new commitments, however, and Tokyo has said that Latin American countries must provide conditions that are more conducive to investment.

But the region's debt problems remain the number-one issue for Japan. Japanese banks reportedly have the second-largest exposure to these debts, holding mainly Mexican and Brazilian loans. As the threat of major defaults has become more worrisome during the past year, Tokyo has made a high-visibility effort to propose new ways to respond to the debt crisis. Its most notable initiative was a \$30 billion three-year aid plan, \$10 billion of which consists of subscriptions to multilateral lending agencies and \$20 billion to be recycled from Japan's public and private sectors. Tokyo has also taken measures to shield its banks from loan losses by approving the establishment of a paper company in the Cayman Islands to buy a portion of nonperforming Mexican loans at a discount (see JEI Report No. 11B, March 20, 1987).

On the multilateral front, officials have indicated their willingness to consider coordination of debt-equity swaps and the establishment of a multilateral debt-purchasing organization. They have also urged ratification of the convention establishing the Multilateral Investment Guarantee Agency (see JEI Report No. 22B, June 12, 1987). To date, Japan is the only industrialized country that has officially approved MIGA. (For a more detailed discussion of Japan's policies concerning the Latin American debt crisis, see JEI Report No. 29A, July 31, 1987.)

Although Tokyo continues to search for creative ways to alleviate debt and development problems in Latin America, it also admits that official development assistance is of limited use in the region. High per-capita income in many countries makes them ineligible for aid. Consequently, even though bilateral aid flows to the region continue to increase, in 1986 they accounted for only 8 percent of Japan's total bilateral disbursements -- less than Asia, Africa and the Middle East (see Figure).

Japan's Foreign Aid by Region, 1986



In light of this obstacle, Tokyo hopes to craft a solution that actively involves the private sector. The 1987 White Paper on International Trade suggests that "Japan should take steps to create an environment in which its current account surplus can be returned to private hands through the mechanisms of the market and flow back smoothly to the debtor nations." The question is whether Latin American countries can offer an investment environment attractive enough to persuade Japanese investors to implement Tokyo's strategy.

Eileen M. Doherty

High Public Support For New Government In Japan

A series of opinion polls published November 12 and 13 in Japan indicates a broad level of popular support for the new government of Noboru Takeshita and suggests that the public expects action on domestic issues rather than foreign policy areas. The surveys show 48 percent of respondents supporting the new government and 22 percent opposing it. This compares favorably with initial surveys for other recent cabinets and is far higher than the first polls for the Nakasone government in 1982 that showed opinion evenly divided at 37 percent for and against the new lineup. Of the last nine governments, the Takeshita regime comes into office with the fourth-highest support level.

A related survey in the Asahi Shimbun -- Japan's second-largest daily and usually considered its most liberal -- showed that voters were interested in three domestic issues: price stability, tax reform and the business climate. Less than 10 percent of those polled thought foreign policy should rank as the government's first priority. Despite this, respondents apparently have very low expectations of the new regime. Nearly 80 percent indicated that they anticipated no changes for better or worse in their personal economic conditions under the new government.

One of the most interesting conclusions of the polls is the overwhelming approval for the consensus style of Mr. Takeshita over the presidential, assertive leadership of Yasuhiro Nakasone. Approximately 70 percent indicated this preference, which stands in marked contradiction to the consistently high public support ratings for the Nakasone government after its first year in office. In fact, after Mr. Nakasone backed off from his politically unpopular proposal for a 5 percent value-added tax, public support for his government rebounded, reaching the 40 percent level in some surveys. The explanation for this divergence might be a fondness for traditional views favoring the consensus decisionmaking process, while separately, the image of Mr. Nakasone as a strong leader who projected a positive image of Japan in the international sphere was undeniably appealing.

Michael W. Chinworth

House Rejects Attempt To Strike Gephardt Amendment

The House of Representatives rejected Minority Leader Robert Michel's (R, Ill.) November 10 attempt to strike the trade bill's controversial Gephardt amendment, which Michel said would lead to "mandatory and unilaterally imposed

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J E I

R E P O R T

NO. 45A

December 4, 1987

THE NEW JAPANESE GOVERNMENT

Summary

There is one thing that observers of the Japanese political scene can agree on when examining the new government headed by Noboru Takeshita: it is not likely to follow the style established by outgoing Prime Minister Yasuhiro Nakasone. The problem is determining the likely course the government will follow under its new premier. All observers look on Japan's new leader as an effective political operator, but critics charge that he is not capable of managing the country's growing domestic concerns and international responsibilities. Mr. Takeshita's supporters insist, however, that his low-key style will be more effective in developing consensus positions among rival interest groups than the approach favored by his highly publicized predecessor.

The Road to Power

Noboru Takeshita falls into the mold of more traditional Japanese politicians, having risen through the ranks with the support of key figures rather than by virtue of his command of the issues. The qualities that carried him to the top are those esteemed in Japanese society -- self-effacement, deference, patience, and above all his Japanese "heart" -- a broad sense of compassion and empathy for his countrymen and Liberal Democratic Party colleagues.

The new prime minister, who will be 64 years old next February, began his political career in 1951 when he was elected to the Shimane Prefectural Assembly at the age of 27. Seven years later he won a seat in the national

Diet's lower house, winning more votes in his district than any other candidate, and has been continuously re-elected ever since. Under former Prime Minister Eisaku Sato Mr. Takeshita served as deputy chief cabinet secretary and became chief cabinet secretary in the last Sato cabinet in 1971. He was again appointed chief cabinet secretary in the 1974 cabinet of Kakuei Tanaka and minister of construction in the 1979 government of Takeo Miki (during which time he also chaired the powerful Budget Committee in the lower house). In addition he was finance minister in two different governments, first under Masayoshi Ohira (1979-80) and then under Yasuhiro Nakasone (November 1982-July 1986).

While Mr. Takeshita had sufficient party and cabinet experience to justify his selection as prime minister, he lacked one of the critical requirements to become LDP president and prime minister: a personal faction committed to his success with a base of supporters to help him achieve power. Mr. Takeshita took over the party's largest faction after carefully wresting control from the faction's former head, Mr. Tanaka. His task was formidable. Under normal circumstances, new leaders inherit their factions with the explicit consent of their predecessors or after a death. The Tanaka faction, however, was in a state of limbo after Mr. Tanaka suffered a crippling stroke in February 1985. While the former "kingmaker" of the LDP failed to recover, no one could risk the possible damage to his reputation by launching an overt effort to seize control. In essence, then, the faction had to be forced on Mr. Takeshita by his supporters within the party.

With the aid of his father-in-law, former Deputy Prime Minister Shin Kanemaru, Mr. Takeshita officially took control last July, setting the stage to campaign against the party's two other "new leaders" -- Finance Minister Kiichi Miyazawa and former Foreign Minister Shintaro Abe. (Another member, Susumu Nikaido, launched an unsuccessful candidacy.) Despite the drama the Japanese media managed to infuse in the campaign, the outcome was never seriously in doubt: Mr. Takeshita had strong support from over a hundred faction members and tentative endorsements from at least two other factions. When Mr. Nakasone was asked to step in at the last minute to mediate, he designated Mr. Takeshita.

This aspect of the succession has been its most interesting element, since Mr. Nakasone did not at the outset have the factional or financial strength necessary to exert that much political leverage. By maintaining a relatively low political posture throughout the campaign and refusing to endorse any candidate directly, he was able to step in at the last minute to save the situation and maximize his influence on the new government. This development once again illustrated Mr. Nakasone's remarkable political acumen and showed why he was able to remain in office for so long despite the tremendous odds against him.

The New Cabinet and Party Line-up

Immediately after his endorsement as LDP president October 31, Mr. Takeshita named Mr. Abe secretary general -- the number-two position in the party -- and appointed Masayoshi Ito executive council chairman and Michio

Watanabe chairman of the policy affairs research committee. Mr. Abe thus becomes Mr. Takeshita's logical successor. Mr. Miyazawa remains finance minister under the new regime and in addition has assumed the post of deputy prime minister, something of a face-saving gesture in light of his unsuccessful bid for the party presidency.

Mr. Watanabe now enters the ranks of future contenders by virtue of his combined party and cabinet expertise, the latter as minister of international trade and industry. His new assignment is critical in developing the network of support necessary to become party president. In terms of day-to-day events within the party and the government, the policy affairs research committee might be the most important position since it allows virtually daily input across a broad range of issues. By contrast, the secretary general is most effective at election time because of his authority relating to candidate endorsement and campaign fund allocations.

Furthermore, the promotion boosts Mr. Watanabe's leadership potential within the Nakasone faction, a significant consideration since he is already viewed as a possible heir. This action also helps moderate Mr. Nakasone's potential influence. Should he attempt too high a political profile, Mr. Takeshita can in effect retaliate by giving Mr. Watanabe more leverage in policy and party affairs, thus threatening the former premier's leadership in his own faction.

Mr. Watanabe's party post has assumed growing prominence in government policymaking in recent years and will allow him to make a significant impact on the new government's positions. In effect, he will oversee the party's stance on virtually every issue and indeed will prepare papers that frequently represent official government positions. In the party he is considered an authority on the tax code, which suggests that tax reform will be one of the most important domestic priorities of the new government.

The new cabinet reflects a delicate balance of intra-party politics and policy considerations. With six seats, the Takeshita faction holds a slight plurality, but in terms of qualitative representation, the Nakasone faction fared extremely well, capturing the portfolios in foreign affairs, posts and telecommunications, and construction. Both the Abe and Miyazawa factions landed four positions of generally comparable status. Abe faction member Takashi Sato heads up the Ministry of Agriculture and Forestry, an important post for anyone with ambitions for the future. Miyazawa supporter Tsutomu Kawara is the new Japan Defense Agency director general, another position that has grown in stature in recent years in response to significant changes in defense policies.

Apparently because of the perception abroad that the new prime minister lacked international experience, Mr. Miyazawa was retained as finance minister. He reportedly agreed to remain in his post for personal as well as policy reasons. His reappointment signals the likelihood of policy continuity in Japan's fiscal and monetary policies. By the same token the new government's foreign policies are likely to remain consistent at least for the short term with the appointment of Sosuke Uno, a Nakasone loyalist, as foreign minister. In commercial and trade policies the same principle holds true, with Hajime Tamura staying on as minister of international trade and industry.

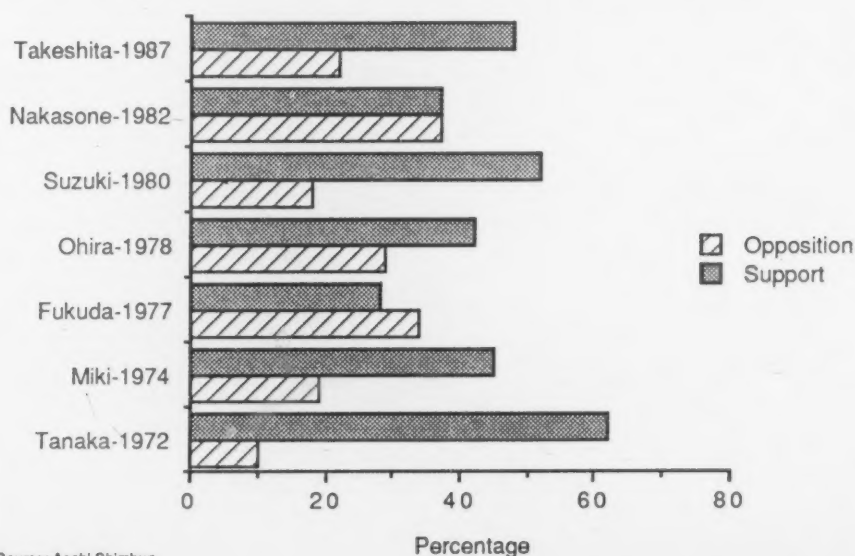
Mr. Kawara's appointment as JDA director general is an interesting one. As the price of support for the Nakasone government when it was first formed, Zenko Suzuki, the head of the faction now led by Mr. Miyazawa, reportedly insisted on the appointment of a member of his group, which was considered less hawkish, as JDA director general. Both JDA appointees in the Nakasone government, Yuko Kurihara and Koichi Kato, were respected, articulate doves on defense. It appears that the Miyazawa faction has inherited that logic in having one of its members named to the position under the Takeshita government. Although there is less information about Mr. Kawara's inclinations since this is his first cabinet appointment, it can be assumed that he is likely to follow the cautious stance of both Mr. Suzuki (whom he served as deputy chief cabinet secretary) and Mr. Miyazawa, while sustaining the general direction of current policies.

Takeshita loyalist Keizo Obuchi is the government's new chief cabinet secretary, under any circumstances an important position but one likely to be even more central in a government headed by a prime minister known more for his consensus-building skills than his policy initiatives. One interesting appointment is that of Abe faction member Shintaro Ishihara, once a somewhat controversial figure because of his staunch nationalism. As the new transportation minister, he has an opportunity to gain a larger national and intra-party following. Finally, the faction of Toshio Komoto is represented in only two positions -- the Ministry of Health and Welfare and the Science and Technology Agency -- reflecting the marginal impact of the faction on the outcome of the LDP presidential race in October.

The First Year's Agenda

Initial public opinion polls indicate a high level of support for the new government (see Figure), which took office November 6. This is fortunate since the problems facing it are multi-faceted and controversial in many respects. One of the key difficulties will be developing consistent positions on a broad range of issues, since several strong-willed individuals occupy important positions in the new government.

Initial Public Opinion Ratings for Japanese Cabinets, 1972-87



Mr. Takeshita's positions on the issues are unclear. This is not a criticism of the new prime minister, since few Japanese politicians follow Mr. Nakasone's example in embracing clear-cut stands on often controversial subjects. His inclinations were presented in a platform released shortly after he announced his candidacy, but they are vague at best, calling on the Japanese people to put their "vitality to work for the world" and embracing the furusato (hometown) ethic -- essentially a stance endorsing the purity of Japanese culture.

Media commentaries in both Japan and the United States have correctly noted that -- for better or worse -- the new cabinet alignment indicates an emphasis on policy continuity on virtually every domestic and international front. Domestically, tax reform is a key priority, while internationally, attention is focused on relations with South Korea, the People's Republic of China and the United States. Mr. Takeshita might try to seize the momentum by arranging personal visits to each of those countries next year. A U.S. visit appears certain in January 1988.

Finance Minister Miyazawa has been outspoken on the direction of international financial policies and Washington's responsibility to rectify its own problems before demanding more of Japan. While it is likely that many -- if not most -- Japanese policymakers and business groups share these perceptions, the remarks might signal almost a reverse psychology in action. It is unrealistic to think that members of the new government do not realize that the impression of the new prime minister in Washington and other capitals is not positive. As a result, some observers have suggested that the government fears increased pressure from abroad arising from an assumption that the Takeshita government is susceptible to arm-twisting. Before such pressure can accelerate, the reasoning goes, it would be better for Japan to go on the offensive and put the responsibility for some of the world's problems where it belongs.

The international issues at the top of the new government's agenda include:

- U.S. Relations - Any Japanese government will place the U.S. relationship at the center of its foreign policy concerns for the foreseeable future. The going could be rough for the next few months, however, there being no easy solutions to the immediate problems facing the two countries. One is the question of construction contracts for foreign firms on public and quasi-public works projects in Japan. New Commerce Department Secretary William Verity took a tough line about the importance of the issue during a mid-November visit to Tokyo, indicating the Reagan administration is not likely to back down. Another problem area is agricultural trade, particularly what Tokyo will do when the current bilateral agreement expanding Japan's beef and citrus import quotas expires next March. Washington hopes for free trade; politically powerful agricultural interests in Japan, of course, seek the opposite.

- PRC Relations - The People's Republic of China has been included in a sweeping ban on Toshiba Machine Co., Ltd.'s exports to communist countries, resulting from that company's sale of sophisticated milling machines to the Soviet Union. With over \$100 million in contracts at stake, Chinese officials seek either reparations or some other form of accommodation. Relations with the PRC are a high priority for Tokyo, so officials are unlikely to let the issue boil too long.

- Iran-Iraq Conflict - Prime Minister Nakasone cautiously took Japan into the troubled waters of the Persian Gulf by promising limited aid in the form of navigational systems for ships in the area. Mr. Takeshita is not likely to take a comparably bold step, but in deference to the United States and as an indication of Tokyo's sensitivity to the fact that Japan imports a considerable amount of oil from the region, the government is attempting to at least keep its hand in diplomatic efforts to resolve the conflict.

In a larger context this might raise issues involving Japan's defense policies. One Japanese commentator has suggested, for example, that promises to assist in critical areas will increasingly look shallow given the larger defense roles Japan could assume around its shores and abroad. Consequently, he suggests, there will be pressure on Tokyo to spend more and assume greater responsibilities. Given the proclivities of key cabinet officials, particularly Mr. Miyazawa, it is likely that Japan will respond with even higher international aid commitments.

- U.S.S.R. Relations - Although relations with the Soviet Union promised to take a distinct turn for the better, matters have been put on ice since Foreign Minister Eduard Shevardnadze's visit to Tokyo in January 1986. The momentum is not likely to shift dramatically under the new government. The U.S.-U.S.S.R. summit is likely to be the primary focus over the short run.

- Maekawa Report Implementation - This report on the internationalization of the Japanese economy was one of the Nakasone government's most publicized economic initiatives. Little has been heard of it in recent months. Overseas skeptics suggest that given the concerns and orientation of the Takeshita cabinet, the new government will pay homage to the same themes but little else. Time will tell.

- Yen Stabilization - The Takeshita government is particularly sensitive to the business community's concerns about the impact of the yen's steep appreciation since February 1985. Finance Minister Miyazawa has played a key role in trying to stabilize the yen-dollar relationship, but it remains to be seen if he will succeed where he has failed in the past.

At the domestic level, the government's policy concerns include:

- Tax Reform - This is the issue that threatened to dissolve the Nakasone government at one point. The LDP and the business community are anxious to revise the tax code to eliminate present inequities and generate new income for the government. The battle could prove to be just as tough this time around, although Takeshita supporters insist that the prime minister's behind-the-scenes maneuvering skills will prove invaluable in this regard.

- Land Prices - Land prices are sky high and rising. Furthermore, the tax code has distorted land utilization. For instance, there is still considerable acreage in suburban Tokyo being used for small-scale farming. It is essential to find ways to relieve the pressure for affordable housing by reversing the spiral in land prices.

- Budget - The cabinet will approve the FY 1988 budget in the near future. Tokyo remains committed to reducing its dependence on deficit financing. With the unexpectedly strong upturn in the domestic economy in recent months, pressure for economic stimulus might moderate and give the government the leeway to reactivate its temporarily shelved policy of cutting the budget shortfall through curbed discretionary spending.

Takeshita's Political Challenge

The alignment of Mr. Takeshita's first cabinet is a transitional arrangement representing policy considerations and political expedience. The prime minister is bound by the support of other major faction leaders in the LDP, just as Mr. Nakasone was linked with former prime minister Tanaka in the early days of his government. Mr. Takeshita faces the challenge of establishing an independent power base and distancing himself from at least one of the other three LDP power blocs in the next year. If he succeeds, it is a virtual certainty that the cabinet will be reshuffled within the next 12 months.

The most likely target of such a realignment would be Mr. Nakasone. Just as Mr. Nakasone was linked by the public with Prime Minister Tanaka, so Mr. Takeshita is viewed in tandem with his predecessor. If Mr. Takeshita is to project an independent image, he must distance himself from Mr. Nakasone and his influence. There are several ways to achieve this goal. The first would be to hold lower house elections in 1988. The election process could be used to weed Nakasone supporters from the ranks of the LDP and replace them with politicians loyal to the Takeshita and Abe camps. Opinion is divided regarding the likelihood of such an election, however. Many observers feel that the party would be well advised to hold on to its overwhelming majority in the lower house at least until the tax reform debate is settled.

A second alternative would be for the Takeshita government to seize on a dramatic yet relatively uncontroversial issue to establish an identity and garner a favorable domestic and international press. Mr. Nakasone was able to score points in Washington early in his administration by exempting the United States from policies restricting exports of military technology. Mr. Takeshita could have similar opportunities in such areas as the Kansai International Airport dispute -- although the signs are not favorable there -- or another sweeping international or bilateral cooperative program. The difficulty here is that it puts Mr. Takeshita in a role to which he is totally unaccustomed: assuming the lead on a highly visible position rather than serving as the power behind the scenes. Consequently, the implementation might be tricky unless it is put in the hands of a Takeshita loyalist who could also make political points by assuming responsibility for the program.

The final method is the time-honored technique of slowly building up one's supporters while whittling away at rival power bases. This is a logical approach for Mr. Takeshita, given his political style and capabilities. Under any circumstances a new prime minister will begin strengthening the power of his key lieutenants by entrusting them with critical responsibilities -- management of the tax reform legislation, for example. This might be the approach with which Mr. Takeshita is most comfortable and it will also gradually serve to distance him from figures such as Mr. Nakasone while preserving his own political options. Finally, it provides ample opportunities for the premier to find a "star" within his circle that he can rely on.

Yasuhiro Nakasone will go down as one of Japan's most effective and skillful politicians in the postwar period. His influence in the new government could be significant in light of his potential input into a proposed government-sponsored think tank that will examine foreign policy issues. And with several faction members in cabinet posts, he retains some power on government issues and operations, although some of those faction members will use their positions to build their own political bases.

The Outlook

Despite the best wishes of his closest supporters, Mr. Takeshita is not likely to assert himself as a formidable figure overseas. In the Japanese context his talents are most appropriate to the domestic arena. He is fortunate in that he is served by highly skilled individuals in certain key posts, and if he is an effective manager of party affairs, government issues -- at least on the domestic front -- could very well take care of themselves. Indeed, the cabinet might have more flexibility and more responsibility in the early days of the new government than might have been the case under a more confident and assertive Nakasone.

The story might be different if the government is faced with a sudden crisis. In such a case it is fair to assume that Mr. Takeshita's natural reaction would be to wait and see rather than take the bold actions sometimes necessary to protect a powerful nation's interests. Consequently, the traditional pattern of reacting to events abroad only in the face of international pressures could re-emerge, perhaps despite the efforts of others anxious to take the country down a new path.

This is not to suggest that Mr. Takeshita lacks an interest in international affairs, but that after so many years of operating behind the scenes in the Japanese political world, he will find it difficult to change his spots. He is an able but colorless politician who has succeeded through the time-honored tradition of waiting his turn to assume office. In deference to that tradition, Mr. Takeshita is also likely to fulfill the role of symbolic overseer of the government. He could very well prove to be an able arbitrator in any number of domestic and international disputes, but he is not likely to seek out issues demanding his attention. The new prime minister will wait for the issues to come to him and even then his first response will be caution.

For further information, contact Michael W. Chinworth.

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The views expressed in this report are those of the author and do not necessarily represent those of the Japan Economic Institute.

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Liberal Democratic Party Positions October 31, 1987

<u>Position</u>	<u>Holder</u>	<u>Age</u>	<u>Faction</u>
President	Noboru Takeshita	63	Takeshita
Secretary General	Shintaro Abe	63	Abe
Executive Council chairman	Masayoshi Ito	74	Miyazawa
Policy Affairs Research Committee chairman	Michio Watanabe	64	Nakasone

The First Takeshita Cabinet
November 6, 1987

<u>Position</u>	<u>Name</u>	<u>Age</u>	<u>Faction</u>
Prime Minister	Noboru Takeshita	63	Takeshita
Deputy Prime Minister	Kiichi Miyazawa	68	Miyazawa
Finance	Kiichi Miyazawa	68	Miyazawa
Justice	Yukio Hayashida	71	Miyazawa
Foreign Affairs	Sosuke Uno	65	Nakasone
Education	Gentaro Nakajima	58	Abe
Health and Welfare	Takao Fujimoto	56	Komoto
Agriculture, Forestry and Fisheries	Takashi Sato	59	Abe
International Trade and Industry	Hajime Tamura	63	Takeshita
Transportation	Shintaro Ishihara	55	Abe
Posts and Telecommunications	Masaaki Nakayama	55	Nakasone
Labor	Taro Nakamura	69	Takeshita
Construction	Ihei Ochi	66	Nakasone
Home Affairs	Seiroku Kajiyama	61	Takeshita
State Ministers			
Chief Cabinet Secretary	Keizo Obuchi	50	Takeshita
Management and Coordination Agency	Osamu Takatori	58	Takeshita
National Land Agency	Seisuke Okuno	74	Unaligned
Japan Defense Agency	Tsutomu Kawara	50	Miyazawa
Economic Planning Agency	Eiichi Nakao	57	Nakasone
Science and Technology Agency	Soihiro Ito	63	Komoto
Environmental Agency	Tohio Horiuchi	69	Abe
Okinawa and Hokkaido Development Agencies	Shigeru Kasuya	61	Miyazawa
Cabinet Legislative Bureau	Osamu Mimura	63	Unaligned

Factional Alignments in the Liberal Democratic Party
October 31, 1987

<u>Faction</u>	<u>Number of Members</u>
Takeshita	114
Miyazawa	89
Nakasone	87
Abe	87
Komoto	31
Nikaido	15
"Neutrals"*	12
Independents	10

*Former Tanaka faction members currently unaligned.

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NO. 45B
December 4, 1987

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Takeshita Opens Special Diet Session

Prime Minister Noboru Takeshita made his first major policy speech at the November 27 opening of a special Diet session, giving a clearer view of his major goals for the coming year. It appears he has his work cut out for him as opposition parties have already strongly criticized his month-old cabinet.

Mr. Takeshita convened the 16-day extraordinary session to address two issues: tax reform and skyrocketing land prices. Despite the difficulties his predecessor had with the subject, Mr. Takeshita made passage of a more balanced tax system the keystone of his fiscal policy, pointing to the costs associated with the rapid aging of the population as the primary reason for seeking new sources of revenue, perhaps including a major indirect tax. Included in this reform package will be major changes in alcoholic beverage taxes to comply with

STATISTICAL SUPPLEMENT

Trade and Payments Data
(in millions of dollars unless otherwise indicated)

	1985	1986	January- September 1986	January- September 1987	July 1987	August 1987	September 1987
Japan's Balance of Payments							
Trade Balance	\$55,986	\$92,827	\$65,267	\$72,011*	\$8,546*	\$6,206*	\$8,848*
Exports (f.o.b.)	174,015	205,591	150,942	162,934*	19,537*	17,177*	19,882*
Imports (f.o.b.)	118,029	112,764	85,675	90,923*	10,991*	10,971*	11,034*
Current Account Balance	49,169	85,845	60,180	64,584*	7,171*	5,305*	8,384*
Long-Term Capital (net)	-64,542	-131,461	-86,282	-98,784*	-18,518*	-1,376*	-2,316*
Overall Balance	-12,318	-44,767	-20,295	-11,119	-10,807	9,295	9,722
International Reserves (end of period)	26,510	42,239	41,456	72,139	69,769	70,726	72,139
Japan's Customs Clearance Trade							
Trade Balance	46,099	82,743	58,851	59,670	6,949	5,153	7,441
Exports (f.o.b.)	175,638	209,151	153,433	166,295	19,899	17,607	20,365
Cars	25,402	32,945	24,434	26,380	3,362	2,706	3,285
Steel	13,566	12,706	9,450	9,052	1,108	1,036	1,042
Imports (c.i.f.)	129,539	126,408	94,582	106,625	12,951	12,454	12,924
Crude Oil	34,599	19,481	15,569	14,892	1,580	1,591	1,664
Japan-U.S. Trade							
Trade Balance	39,485	51,401	36,846	38,031	4,791	3,730	4,869
Exports (f.o.b.)	65,278	80,456	58,910	60,825	7,639	6,397	7,599
Imports (c.i.f.)	25,793	29,054	22,064	22,794	2,848	2,667	2,730
U.S.-Japan Trade							
Trade Balance (f.a.s./c.i.f.)	-49,749	-58,575	-43,028	-44,323	-5,074	-4,879	-4,632
Exports (f.a.s.)	22,631	26,882	20,301	20,217	2,561	2,658	2,424
Imports (c.i.f.)	72,380	85,457	63,328	64,540	7,635	7,536	7,057
Trade Balance (f.a.s./Customs)	-46,152	-55,030	-40,340	-41,775	-4,779	-4,585	-4,357
Exports (f.a.s.)	22,631	26,882	20,301	20,217	2,561	2,658	2,424
Industrial Supplies	8,680	8,752	6,281	7,234	838	924	842
Capital Goods	5,939	6,728	4,815	5,438	826	644	737
Food and Feed	5,001	5,043	3,754	4,120	511	664	471
Consumer Goods	1,416	1,690	1,239	1,890	228	236	219
Imports (Customs)	68,783	81,911	60,641	61,992	7,341	7,242	6,781
Automotive Products	24,980	32,849	24,116	24,815	2,902	2,953	2,462
Capital Goods	21,516	25,334	18,740	21,097	2,524	2,445	2,435
Consumer Goods	14,017	15,451	11,458	9,711	1,182	1,122	1,201
Industrial Supplies	7,035	6,949	5,339	5,437	623	609	567

*Preliminary

STATISTICAL SUPPLEMENT

Japanese Economic Indicators

(percentage change from year-earlier period unless otherwise indicated)

	1985	1986	January- September 1986	January- September 1987	July 1987	August 1987	September 1987
<u>Discount Rate (end of period)</u>	5.0%	3.0%	3.5%	2.5%	2.5%	2.5%	2.5%
<u>Outstanding Money Supply</u>	8.4%	8.7%	8.8%	9.9%	10.3%	11.0%	11.1%
<u>Industrial Production</u>	4.6%	-0.4%	-0.2%	2.1%	4.1%	5.0%	5.3%
<u>Manufacturing Operating Rate</u>	1.2%	-4.8%	-4.3%	-0.7%	0.2%	2.6%	3.9%
<u>Number of Bankruptcies</u>	-9.7%	-7.1%	-7.1%	-17.8%	-30.7%	-29.1%	-32.0%
<u>Residential Construction Starts</u>	4.1%	10.4%	8.7%	22.1%	27.2%	30.9%	26.8%
<u>Job Openings to Applications (ratio)</u>	0.68	0.62	0.63	0.66	0.70	0.71	0.74
<u>Nominal Wages</u>	3.6%	3.5%	3.8%	2.4%	1.8%	1.0%	3.0%
<u>Labor Productivity</u>	4.2%	2.3%	2.2%*	3.2%*	n.a.	n.a.	n.a.
<u>Wholesale Prices</u>	-1.1%	-9.3%	-9.0%	-5.1%	-2.2%	-1.1%	-0.2%
<u>Consumer Prices</u>	2.0%	0.6%	0.9%	-0.1%	0.1%	0.4%	0.8%
<u>Yen-Based Export Prices</u>	-1.4%	-14.5%	-16.0%	-4.9%	-0.4%	0.7%	-0.9%
<u>Yen-Based Import Prices</u>	-2.5%	-34.7%	-34.1%	-10.9%	5.6%	12.3%	7.3%

*Through June of each year only.

For Japan's most recent GNP figures, see JEI Report No. 36B, September 25, 1987.

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NO. 46B
December 11, 1987

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Japanese Economy Shows Rapid Growth

The Japanese economy expanded at a real annual rate of 8.4 percent in the June-September period compared to a flat performance in the previous three months, the Economic Planning Agency reported December 4 (see Table). On a quarter-to-quarter basis, growth hit 2 percent for the first time since January-March 1977. Despite the spurt, the EPA stressed that the economy was not overheating, pointing out that both wholesale and consumer prices are fairly stable.

In December 1986 the government set 3.5 percent as the target growth rate for real gross national product for fiscal 1987, which ends March 31, 1988. Compared to private forecasts issued at the time, this prediction was optimistic, although it now appears achievable. Public works spending is expected to have a big impact in the second half of the fiscal year, and a rise

Japan's Real Gross National Product at Constant (1980) Prices

(in billions of yen, seasonally adjusted, quarterly totals and rates of growth at annual rates)

	FY 1985	FY 1986	October- December 1986	January- March 1987	April- June 1987	July- September 1987
Gross National Product	Y293,903.6 (4.4%)	Y301,679.7 (2.6%)	Y302,299.0 (2.8%)	Y306,780.1 (6.1%)	Y306,805.8 (0.0%)	Y313,046.7 (8.4%)
Personal Consumption Spending	163,315.8 (2.8%)	169,195.1 (3.6%)	168,584.8 (-2.3%)	171,935.2 (8.2%)	173,089.9 (2.7%)	174,678.2 (3.7%)
Private Residential Construction	14,095.9 (2.9%)	15,637.9 (10.9%)	16,263.4 (22.6%)	16,459.1 (4.9%)	16,950.2 (12.5%)	18,696.9 (48.0%)
Private Fixed Nonresidential Investment	53,920.4 (13.2%)	56,361.2 (4.5%)	56,543.9 (7.3%)	57,949.6 (10.3%)	58,973.3 (7.3%)	60,292.3 (9.3%)
Change in Business Inventories	2,036.0, (*)	515.2 (*)	885.7 (*)	143.9 (*)	906.7 (*)	1,046.3 (*)
Government Current Expenditures	27,158.2 (1.6%)	29,002.0 (6.8%)	31,983.9 (70.9%)	28,384.9 (-38.0%)	28,726.6 (4.9%)	28,631.7 (-1.3%)
Government Fixed Investment	20,796.1 (-6.3%)	22,162.2 (6.6%)	22,262.1 (3.6%)	22,417.9 (2.8%)	22,797.4 (6.9%)	23,545.4 (13.8%)
Change in Government Inventories	297.8 (*)	816.0 (*)	-1,891.6 (*)	226.2 (*)	-102.2 (*)	-9.2 (*)
Net External Sector	12,283.4 (20.9%)	7,990.1 (-35.0%)	7,666.9 (13.5%)	9,263.3 (113.1%)	5,463.9 (-87.9%)	6,165.1 (62.1%)
Exports of Goods and Services and Factor Income Received	54,664.2 (2.1%)	52,689.5 (-3.6%)	52,147.6 (-2.3%)	53,451.0 (10.4%)	52,466.1 (-7.2%)	55,958.2 (29.4%)
Imports of Goods and Services and Factor Income Paid	42,380.8 (-2.3%)	44,699.5 (5.5%)	44,480.7 (-4.8%)	44,187.7 (-2.6%)	47,002.2 (28.0%)	49,793.1 (26.0%)

*Cannot be calculated or meaningless.

Source: Economic Planning Agency

at an annual rate of only 1.2 percent for the rest of the fiscal year would lift GNP to the target level.

The growth of domestic demand was broad-based in the July-September period, with no sectors acting as drags on the economy. Housing was the strongest sector, increasing 48 percent on an annualized basis and accounting for almost 30 percent of the expansion. Residential construction has been strengthening for more than a year, thanks in part to a decline in mortgage rates. Consumer spending was sluggish only when compared to other sectors, contributing 25 percent of the total. Government investment also expanded rapidly, accounting for 12 percent of growth, reflecting the front-loading of public works spending.

External demand contributed 11 percent, a substantial change from the April-June quarter when it had actually shrunk. While the latest figures would appear to suggest that the trade surplus has stopped declining, EPA analysts said that was not the case: net external demand was larger because income on foreign investments, particularly in the United States, grew rapidly. This brings up a complicating factor in the bilateral current account. Even if Japan's imports from the United States increase and its exports to this country fall, the bilateral surplus might not decline if investment in the United States rises significantly. The EPA said it expected net foreign demand to return to a negative trend in the October-December quarter.

In general, the GNP report is very good news for officials in Tokyo and Washington. Growth was substantial in those areas that most directly indicate improvements in the standard of living: housing and consumer expenditures. The data also show that Japan is, as the United States has persistently requested, reflating its economy. In time, growth in Japan may make it a little easier for the United States to reduce its own trade deficit and to stabilize the value of the dollar.

Douglas Ostrom

Japan Escapes Criticism On Macroeconomic Policies

Japan's monetary and fiscal policies are just fine, the world's economic leaders seem to be saying. Of course there is some displeasure over the bidding on the Kansai International Airport and agricultural imports continue to rile Washington, to name only two issues, but few foreign officials say anything critical about Tokyo's macroeconomic policies.

At the last Group of Seven meeting in February, Japan and West Germany agreed to reflate their economies and the United States promised action on its budget deficit. Taken together, the policies were seen as part of a package to stabilize the value of the world's major currencies. In the past few months, international currencies have been anything but stable. Clearly something went wrong. The United States fingered Western Europe, especially West Germany, for not reflating enough. The Europeans and the Japanese have lectured the United States for doing almost nothing about its budget deficit. No one has criticized Japan. Michael Camdessus, the International Monetary Fund's managing director, has said "Japan is behaving very well."

is the case in the United States, Japanese regulators are worried about possible conflicts of interest and liability questions. If the investment operations sustain a heavy loss, for example, the assets of the commercial banking operations must not be used to offset the losses, and vice versa. In another example, regulators want to insure that banking assets will remain beyond the reach of legal actions directed at the securities subsidiary -- the corporate veil must remain inviolate.

Next summer the council will study implementation measures. Although some reference to Article 65 is unavoidable, the head of the council does not expect to delve deeply into the subject. All of this means that nothing, beyond the broad generalities of the council's recommendations, has been firmly decided. All sides can be expected to increase lobbying and other efforts before any legislation is submitted.

Jon Choy

Japan's Aid Program Criticized

Japan ran into a barrage of criticism during the annual talks of the Development Assistance Committee of the Organization for Economic Cooperation and Development. Committee members, who convened December 1 and 2 to discuss ways to improve DAC guidelines on development assistance, urged Tokyo to increase its official development assistance to at least the DAC target level -- 0.7 percent of gross national product. Japan's ratio was only 0.29 percent in 1986 -- putting it 14th of the 18 members. (Only Ireland, New Zealand, the United States and Austria had lower ratios than Japan.)

The DAC also criticized Tokyo's capital-intensive aid programs, saying that Japan's ODA focuses on capital-intensive projects to a much greater extent than that of most other donors. More than 45 percent of last year's aid was earmarked for improvements in public utilities, industrial, mining and construction projects (see Table). Members noted that such projects can lead to the informal tying of aid to Japanese exports, since their completion requires foreign supplies of sophisticated equipment, especially in the areas of telecommunications, power generation and transportation.

Japan replied that its plan to recycle \$20 billion of its current account surplus to the developing countries was evidence of its commitment to the third world and its willingness to contribute to international economic stability (see JEI Report No. 41A, October 30, 1987). Officials also emphasized a \$500 million fund for Africa that will consist primarily of grant aid. But the fact that the DAC members singled Tokyo out for criticism indicates that the aid initiatives will be of limited public relations value unless Japan moves to improve other measures of its ODA. This means improving not only the ODA/GNP ratio, but also the grant element of ODA, a measure of the quality of aid. At 80 percent in 1986, Japan fell below the DAC's 86 percent target, but was significantly above its 73.5 percent level in 1985.

Tokyo's aid efforts during the last few weeks have focused on Southeast Asia. Officials met with representatives from the Association of Southeast Asian Nations November 30 to discuss the specifics of a \$2 billion fund that Prime Minister Noboru Takeshita is expected to announce in mid-December at the

Manila ASEAN summit (see JEI Report No. 39B, October 16, 1987). The package, which is part of the \$20 billion recycling fund, is expected to consist primarily of low-interest loans. ASEAN members have reportedly been pressuring Tokyo to agree to lower interest rates than it has in the past, since the yen's appreciation has made repayment of existing debts difficult for countries such as Indonesia, Malaysia and the Philippines. News reports indicate that although the Ministry of Foreign Affairs supports the idea, the Ministry of Finance fears that lowering interest rates on ASEAN Fund loans might establish a precedent for future aid flows.

Eileen M. Doherty

Distribution of Japan's Bilateral ODA Commitments, 1985-86*

(in millions of dollars)

	1985	1986	Percent Change 1985/86	Percent of Total	
				1985	1986
Public utilities	\$1,756.6	\$1,510.8	-14.0%	43.1%	34.8%-
Planning and public administration	25.8	30.8	19.4	0.6	0.7
Agriculture and fisheries	699.5	521.9	-25.5	17.2	12.0
Industry, mining and construction	432.1	530.5	22.8	10.6	12.2
Trade, banking, tourism and services	18.7	30.7	64.2	0.5	0.7
Education	317.8	362.6	14.1	7.8	8.4
Health	161.9	135.5	-16.3	4.0	3.1
Social infrastructure and welfare	117.7	158.1	34.3	2.9	3.6
Multi-sector	98.6	23.7	-76.0	2.4	0.5
Unspecified**	144.6	245.4	69.7	3.6	5.7
Not allocable by sector***	302.4	792.0	161.9	7.4	18.2
Total	4,075.6	4,341.9	6.5	100.0	100.0

*Commitment basis.

**Includes administrative costs.

***Includes commodity loans, food aid, debt relief and other types of aid.

Notes

JAL, NTT Stock Sales - Tokyo's fiscal constraints have been eased, in large part due to the highly successful auctions of government-held shares of Nippon Telegraph and Telephone Corp., which dominates the nation's domestic telecommunications market, and Japan Air Lines Co., Ltd., the world's largest international carrier in terms of passengers carried.

J A P A N · E C O N O M I C · I N S T I T U T E

J E I

R E P O R T

NO. 47B
December 18, 1987

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Takeshita's High-Stakes U.S. Visit

The month-old government of Noboru Takeshita is already facing potential political difficulties at home, giving his mid-January trip to the United States more significance than was originally expected. The prime minister suffered his first drop in the public opinion polls even before having a serious opportunity to affect policies in Tokyo. While the dip is not significant and other governments have witnessed similar popularity declines in their early months, it appeared surprisingly quickly. This suggests that voters may have become more skeptical about the new premier and will be less tolerant of his administration should it face a serious test during the coming year.

The problems involve both old and new issues. An old one is tax reform, which threatened to dissolve the Nakasone government last spring. The Liberal Democratic Party has modified its position on the subject over the past several months, but still considers it a major policy objective. Voters know instinc-

Dollar Sinks And Yen Soars

The yen crashed through another barrier, rising above 130 yen to the dollar for the first time on December 10. In mid-October, prior to the stock market debacle, its value had been close to 150 yen to the dollar. Since early 1985 the dollar has lost more than half its value relative to the yen.

The strong currency is bad news for Japanese exporters. While profits had been rising recently, they had not recovered to the levels reached before the yen began its rapid ascent. The speed of the most recent rise, with a 13 percent increase against the dollar since the end of September, complicates planning for Japanese companies, especially those that used Y130=\$1.00 as a benchmark.

The dollar's latest plunge began immediately after the Commerce Department released October's unexpectedly disastrous trade figures. The markets had been bracing for the new numbers for some time, especially after the release of September's figures, which were also an unpleasant surprise and presaged the stock market collapse on October 19. Market analysts see negative trade figures as evidence that the dollar has to fall further to bring trade closer to balance. The markets apparently decided it was unlikely that the Federal Reserve Board would choose to fight the trade deficit by tightening the money supply, a move that might be expected to increase net capital inflows, demand for dollars, and the value of the dollar. This course of action, which has been forcibly argued by the British, would increase the likelihood of an election-year recession.

A few hours before the U.S. trade statistics for October were announced, Tokyo had released its November trade figures, which almost got lost in the confusion. Arguably more important since they are more current, the data showed a 36 percent year-to-year drop in Japan's dollar-denominated trade surplus. These data seem to suggest that the strong yen of recent months is having an effect: imports are strong and exports are sluggish. If anything, the reaction in currency markets should have been a weaker yen. Instead, in the markets then open in Tokyo, London and Hong Kong, traders just yawned, waiting to be jolted awake by the news from Washington.

The markets' differing reactions to the two sets of figures reflect in part the reality that the United States and Japan do not just trade with each other, important as that trade is. If trade were strictly bilateral the Japanese figures should be more important, being more current. In fact, each nation has other partners and other exchange rates: a big drop in Japan's November surplus does not necessarily mean we will see a big drop in the U.S. trade deficit for the same month when Washington releases its figures a month from now. Nor is the dollar's drop quite the same thing as the yen's rise. As the table below shows, in both the period since the Plaza Accord (see JEI Report No. 38B, October 4, 1985) and since just before the stock market crash, the yen has been strong against the dollar and the Korean won, but almost stable against the German mark.

Changes in the Yen, September 1985 - Mid-December 1987

	<u>October 1, 1985- December 12, 1987</u>	<u>October 1, 1987- December 12, 1987</u>
German mark (DM)	+3.3	+1.6
Korean won	+51.8	+13.6
U.S. dollar	+88.6	+15.0

The relative weakness of the yen against the mark (and other European currencies) suggests that the recent turmoil is more a result of a weak dollar than a strong yen. The strength of the yen against Asian currencies, several of which are closely tied to the dollar, suggests that much of any further improvement in Japan's trade figures may come from increased imports from Asia. In September, the latest month for which figures are available, about 25 percent of Japanese imports came from the United States, but 14 percent came from the "Four Tigers" -- South Korea, Taiwan, Hong Kong and Singapore. Imports from these countries have been sharply higher in recent months. While the dollar's drop might increase the share of Japan's imports from the United States, the dynamic economies of East Asia are likely to benefit even more, especially if their currencies continue to be weak against the yen.

Douglas Ostrom

Japan Joins In Landmark International Bank Agreement

In the not so distant past, individual governments around the world decided independently how to regulate their financial institutions. But now, the Bank for International Settlements has announced a proposal to establish uniform capital adequacy ratios for the world's banks. This initiative, based on discussions among the financial leaders of the world's leading industrial powers, is potentially of great significance for the international competitiveness of the financial institutions here, in Japan and in Europe.

Capital adequacy ratios are one measure of a bank's financial health: a larger ratio means a larger cushion against loss (see JEI Report No. 32B, August 21, 1987). Regulators set minimum capital adequacy ratios to reduce the chances of bank failure, but having to maintain a minimum ratio can mean reduced profits for banks.

Japan dominates the ranks of global banking if size is measured by assets denominated in dollars, with 12 of the world's 20 largest institutions. Japanese banks have a low ratio of capital to total assets, generally reported to be in the range of 2.5 to 3 percent. U.S. banks average around 5 percent, although the second largest, Bank of America, has a ratio of only 2.39 percent. Some interpretations of Japanese dominance point to these low capital requirements. If this analysis is correct, the proposed regulations will remove that advantage.

The ratio refers to what is known as "core capital," which would be raised to 4 percent for banks worldwide under the BIS proposal. But core capital does not reflect so-called hidden reserves, such as appreciated assets, which are important for Japanese banks. Tokyo monetary authorities pressed for their inclusion in the formula and were partly successful; 45 percent of hidden reserves will be added to both capital and assets for purposes of a second, more inclusive, capital ratio. This ratio now averages about 5.5 percent for Japanese banks, but under the new regulations they will have to raise it to 8 percent by 1992.

The new requirements pose difficult choices for Japanese banks. For example, if they retain their present loan margins, even though earnings on assets remain unchanged, the banks will become less profitable as measured by

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FY 1988 Budget: Outlays Up, Taxes Too

Japan's fiscal policy will continue to play a stimulative role in fiscal 1988 (starting April 1, 1988) if the government of Prime Minister Noboru Takeshita has its way. On December 28 the cabinet approved a 4.8 percent increase in the overall general account budget, the largest increase in initial spending plans in six years. In addition a 9.4 percent increase is planned for the Fiscal Investment and Loan Program, a separate capital budget. On the revenue side, higher-than-expected income will allow a drastic reduction in the amount of new government borrowing, and tax receipts are expected to show healthy growth. The budget illustrates how the new prime minister can work behind the scenes to achieve his policy objectives. Significant modifications

to the Ministry of Finance's proposed budget were made in the week between its submission and the cabinet's approval.

Mr. Takeshita is following his predecessor's practice of favoring a few general account spending areas while trying to reduce the current deficit. Leading the spending increase parade (see Table 1) is defense at 5.2 percent, followed by foreign aid (5.1 percent) and social security (2.9 percent). Although total spending for education will rise just 0.2 percent, outlays for science and technology (which are included in this total) will grow 4.2 percent. On the other hand, spending cuts are planned for food support programs (17.1 percent), energy projects (6.8 percent), small business assistance (6.8 percent), and pensions (0.8 percent). Altogether, discretionary outlays will show a 1.2 percent gain to Y32,982.1 billion (\$263.9 billion at Y125=\$1.00), the first significant rise since FY 1984.

Table 1: Summary of FY 1988 General Account Outlays

(in billions of yen; change from initial FY 1987 budget)

<u>Discretionary Items</u>		
Social Security	Y10,384.5	2.9%
Education and Science	4,858.1	0.2
Pensions	1,879.8	-0.8
Defense	3,700.3	5.2
Public Works	6,017.3	0.0
Economic Cooperation	682.2	5.1
Disaster Reconstruction	65.1	0.0
Small Business Measures	195.2	-6.8
Food Control Programs	448.2	-17.1
Energy Measures	461.6	-6.8
Other	3,939.8	0.6
Reserves	350.0	0.0
Total	32,982.1	1.2
<u>Nondiscretionary Items</u>		
Transfers to Local Government	10,905.6	7.1
Debt Service	11,512.0	1.6
Transfer of NTT Proceeds to Public Works	1,300.0	*
Total	23,717.6	10.2
<u>Total</u>	56,699.7	4.8

*New category

Source: Ministry of Finance

The cost of servicing the nation's debt will rise 1.6 percent, well above the initial plan for the current fiscal year (0.1 percent) but far below the generally double-digit increases set during the FY 1980-FY 1986 period. Interest payments will therefore account for 20.3 percent of total outlays, down slightly from FY 1987's projected 20.9 percent level. Because of surplus FY 1987 tax receipts and projected revenue growth in fiscal 1988, transfers to

local governments (which are fixed at a percentage of total central government tax revenues) will jump 7.1 percent. Combined with proceeds from the sale of government-held shares of Nippon Telegraph and Telephone Corp., nondiscretionary spending will expand 10.2 percent.

At first glance it appears that public works expenditures will be held to FY 1987's Y6,017.3 billion (\$48.1 billion) level. Thanks to the money earned from the sale of its NTT stock, however, Tokyo will actually spend more on roads, sewers and other infrastructures in FY 1988 -- just under Y1.3 trillion (\$10.4 billion) more. The special addition translates into a sharp 21 percent increase in public investment, much of which is again likely to be spent during the first half of the fiscal year.

The stimulus provided by the general account will be solidly supported by Fiscal Investment and Loan Program outlays of Y29,614.0 billion (\$236.9 billion), well above FY 1987's Y27,081.3 billion (\$216.7 billion) initial level. Housing, public service facilities, roads, and trade promotion and economic cooperation will receive the lion's share of the increase (see Table 2). Unlike the general account budget, the FILP budget is funded mainly by government trust funds (see Table 3), although a handful of specific commodity taxes play a role.

Table 2: Fiscal Investment and Loan Program Outlays, FY 1987-FY 1988

(in billions of yen; change from initial budget of previous year)

	FY 1987		FY 1988	
	Amount	Change	Amount	Change
Housing	Y6,328.2	8.1%	Y6,921.5	9.4%
Public Service Facilities	3,998.7	8.2	4,450.9	11.3
Welfare	627.7	0.3	661.8	5.4
Education	784.1	15.6	637.6	-18.7
Small Business	3,985.6	7.7	4,030.6	1.1
Agriculture	907.8	0.6	979.4	7.9
Land Conservation and Disaster Reconstruction	493.0	16.6	409.8	-16.9
Roads	2,363.0	16.7	2,512.1	6.3
Transportation and Communications	2,264.1	12.4	2,229.9	1.5
Regional Development	657.7	16.2	652.2	-0.8
Industry and Technology	630.9	-0.0	687.2	8.9
Trade Promotion and Economic Cooperation	690.5	-33.2	1,171.0	69.6
Capital Utilization	3,350.0	*	4,270.0	27.6
Total	27,081.3	22.2	29,614.0	9.4

*New category

Source: Ministry of Finance

Table 3: Fiscal Investment and Loan Program Sources, FY 1987-FY 1988

(in billions of yen; change from intital budget of previous year)

	FY 1987		FY 1988	
	Amount	Change	Amount	Change
Industrial Investment Special Account	Y144.3	134.6%	Y91.2	-36.8%
Trust Fund Bureau	24,595.8	18.6	26,206.6	6.5
Postal Savings	7,900.0	12.9	7,900.0	0.0
Pension Contributions	4,450.0	3.5	3,500.0	-21.3
Other Revenues	12,245.8	29.7	14,806.6	20.9
Postal Life Insurance Fund	3,941.2	25.3	4,409.4	11.9
Government-Guaranteed Bonds and Borrowings	2,400.0	-25.2	2,406.8	2.8
Total	31,081.3	14.5	33,114.0	6.5

Source: Ministry of Finance

On the revenue side of the general account budget, tax receipts are expected to expand a strong 9.5 percent to Y45,090 billion (\$360.7 billion) due to the recovery of corporate profits and the continuing boom in financial and real estate transactions. While another sale of lucrative NTT stock will pour an estimated Y2,768.7 billion (\$22.1 billion) into government coffers in FY 1988, only Y1.3 trillion (\$10.4 billion) will be explicitly included in the general account budget.

A total of Y8,841 billion (\$70.7 billion) in bonds will be issued in FY 1988 (Y3,151 billion or \$25.2 billion in deficit-financing bonds and Y5,690 billion or \$45.5 billion in construction bonds), a whopping 15.8 percent decline from the figure originally projected for the current fiscal year. The reduction is composed of a Y1,830 billion (\$14.6 billion) cut in new deficit-financing bonds and a Y170 billion (\$1.4 billion) increase in construction bond issues. This will reduce reliance on bond issues to just 15.6 percent of total revenues, down sharply from this year's initial projection of 19.4 percent. If the government maintains this rate of deficit-financing reduction, it will achieve its goal of eliminating this type of borrowing by fiscal 1990.

Finally, receipts from other sources will drop 39 percent to Y1,468.7 billion (\$11.7 billion), bringing total revenues to Y56,699.7 billion (\$453.6 billion). Major changes in tax policy are not envisioned in FY 1988. Learning from his predecessor's experience, Mr. Takeshita is taking time to prepare a national consensus on tax reform (including a major indirect tax) before submitting legislation.

An important aspect of the FY 1988 general account budget was that it barely resembled the proposal submitted to the cabinet by the Ministry of Finance December 22 (see Table 4). In order to leave overall spending levels unchanged and bolster some categories, almost every discretionary item was adjusted. Since each ministry must approve the changes, Mr. Takeshita must have used his consensus-building skills to the fullest during the week of negotiations. It was an impressive display of the Takeshita style of government and could bode well for resolution of international frictions.

Table 4: Comparison of Proposed and Approved FY 1988 Discretionary Outlays

(in billions of yen)

	<u>Proposed</u>	<u>Approved</u>
Social Security	Y10,352.2	Y10,384.5
Education and Science	4,784.2	4,858.1
Pensions	1,859.1	1,879.8
Defense	3,670.6	3,700.3
Public Works	6,017.3	6,017.3
Economic Cooperation	672.1	682.2
Disaster Reconstruction	65.1	65.1
Small Business Measures	190.1	195.2
Food Control Programs	438.1	448.2
Energy Measures	460.2	461.6
Other	4,043.0	3,939.8
Reserves	350.0	350.0

Source: Ministry of Finance

Despite all the hoopla from Tokyo, some foreign observers are skeptical that the FY 1988 budget represents a significant change. They point out that the initial FY 1988 budget is on par with the revised spending plan for FY 1987 if the large supplementary budget is included (see JEI Report No. 25B, July 2, 1987). A comparison shows outlays for public works at Y7,211.3 billion (\$57.7 billion) in FY 1987 versus Y7,282 (\$58.3 billion) in fiscal 1988; Y408.6 billion (\$3.3 billion) for disaster reconstruction compared to the Y65.1 billion (\$521 million) planned for FY 1988; economic cooperation worth Y667.5 billion (\$5.3 billion) in FY 1987 and Y682.2 billion (\$5.5 billion) next fiscal year; support for small business should total Y238.7 billion (\$1.9 billion) by March 31, 1988 with only Y195.2 billion (\$1.6 billion) planned for the next 12 months; and miscellaneous outlays will amount to Y4,398.4 billion (\$35.2 billion) in FY 1987 as opposed to a projected Y3,939.8 billion (\$31.5 billion) in FY 1988.

At first glance the argument is well taken. The chances that the FY 1988 supplementary budget will not add to total outlays for the fiscal year is very small. (Disaster reconstruction in particular is allotted the majority of its funds in the supplementary budget.) How much it will add is the key question. If the economy needs a boost, Mr. Takeshita could put together a big supplementary spending package; if not, then the supplementary budget may be less. In any case, it is unlikely that the prime minister will allow FY 1988 spending to be less than FY 1987's adjusted level, particularly for technology promotion, defense, foreign aid and public works.

Jon Choy

Government Sees Continued Economic Expansion

Shaking off the effects of a rising yen, the Japanese economy is moving from a recovery phase into expansion, according to the fiscal 1988 economic outlook considered by the cabinet December 22. Real GNP is now expected to rise 3.7 percent in FY 1987, an upward revision from the December 1986 estimate of an inflation-adjusted 3.5 percent. Growth will increase slightly in FY 1988 to 3.8 percent. The figures are remarkably close to the private sector's average estimate of a 3.7 percent expansion in FY 1987 and a 3.6 percent gain in FY 1988.

The government's economic outlook is especially important since it establishes a framework for the budget. The Ministry of International Trade and Industry and the Finance Ministry disagreed about the appropriate growth target for FY 1988. MITI argued for 4 percent to conform to the medium-term figure recommended in the Maekawa report on economic restructuring. The Finance Ministry, worried about the larger government expenditures required to obtain faster growth, preferred a lower 3.6 percent. The Economic Planning Agency, acting as mediator, exactly split the difference, coming up with 3.8 percent.

The government anticipates a comparatively stable international economic situation during the April 1988-March 1989 period, with prices, including oil, rising slowly and interest rates remaining moderate. The outlook assumes the yen will trade at an average of 133 to the dollar, a rate that implies a reversal of the dollar's recent decline.

Government's FY 1988 Economic Outlook

(percent change except where noted)

	<u>Actual</u> <u>FY 1986</u>	<u>Estimated</u> <u>FY 1987</u>	<u>Outlook</u> <u>FY 1988</u>
Real Gross National Product	2.6%	3.7%	3.8%
Consumer Spending	3.6	3.6	3.8
Residential Construction	10.9	16.5	1.9
Capital Spending	4.5	7.1	9.8
Contribution of Domestic Demand to Change in Real GNP (percentage points)	4.1	5.0	4.7
Contribution of External Demand to Change in Real GNP (percentage points)	-1.5	-1.3	-1.0
Current Account Surplus (billions of dollars)	94.1	82.0	72.0
Wholesale Prices	-9.4	-1.7	0.3
Consumer Prices	0.0	0.7	1.3

Domestic demand, spurred by public works spending, is expected to propel the economy for the rest of FY 1987 and FY 1988. Included in Tokyo's economic outlook is a long list of things the government would like to do. Some groups and industries are singled out for special attention: the aged, small and medium businesses, fisheries and forestry industries, mineral resources and knowledge-intensive activities, to name a few. The government reaffirmed Tokyo's dedication to free trade and pledged increased market access, liberalization of financial markets and a stronger commitment to international cooperation in basic research.

Both Japan's current account and trade surpluses are expected to continue to shrink. In FY 1988 the current account surplus is projected at \$72 billion, a reduction of \$10 billion from FY 1987's anticipated number and \$22 billion below the actual FY 1986 figure. While declining surpluses drag down the rate of economic growth in Japan, so far their impact has been moderate compared to the positive contribution that net exports made to economic growth between 1982 and 1986. Even if the projection for the FY 1988 current account proves correct, in dollar terms it will still be the third-largest surplus in Japanese history.

Douglas Ostrom

Dollar Ends Depressing Year Still On The Skids

In the spirit of the season, governments here and abroad showered gifts on the currency markets in the hope that they in turn might show a little charity toward the dollar, but to little avail. The dollar ended 1987 as pathetically as it ended 1986 -- by dropping to another postwar low. In Tokyo the dollar closed the year at ¥122, a 30.4 percent drop over 1986's yearend rate.

While most of the gifts arrived before Christmas, the markets still seemed to think they were too little and too late. For example, on December 22 President Reagan signed into law measures that, among other things, promised to reduce the U.S. budget deficit by about \$33 billion in fiscal 1988, ending September 30, 1988, and by over \$40 billion in fiscal 1989. The idea was Washington would borrow less and the U.S. economy would require less capital from abroad. Reduced foreign investment requirements call for a smaller spread between U.S. and overseas interest rates, a notion appealing to the Europeans and the Japanese because they would then face less pressure to lower their rates.

But many economists found little to cheer about in the deficit-reduction measures. They pointed out that the actual impact was even less than it appeared since certain of the mandated budget savings did not reduce domestic demands on capital markets.

The measures might reduce the Japanese trade surplus a little. In November Japan's Economic Planning Agency used its world economic model to estimate the impact of a U.S. deficit reduction somewhat larger than the one actually enacted. It showed that a cut of 1 percent of nominal gross domestic product (the actual reduction was no more than 0.7 percent), lasting for at least three years, would, by the third year, reduce Japan's trade surplus by about \$6 billion a year, or 6 to 10 percent. While not a dramatic drop, the deficit-reduction program would do more to cut the Japanese trade surplus than many, if not all, of the market opening actions Washington has been pushing on Tokyo.

J A P A N · E C O N O M I C · I N S T I T U T E

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R E P O R T

NO. 2A

January 15, 1988

JAPAN'S LABOR UNIONS WORK TO MEET NEW CHALLENGES

Summary

Japan's workforce and labor unions are facing the twin challenges of economic evolution and a strong yen, and like American labor in the early 1980s, could emerge from the ordeal significantly transformed. The changing economic, social and demographic situation demands creative responses from government, industry and labor leaders -- responses that are now being debated. As in the past, the Japanese will evaluate traditional labor practices, keeping or amending some while discarding others.

The Japanese Tradition

Japanese employment practices reflect the dual nature of the business sector. At the top, employees of big companies enjoy a lifetime employment system that offers security and steady advancement in exchange for near-absolute loyalty. Workers in small firms, on the other hand, face hiring and firing conditions similar to American practices. When times are tough, workers often bear the brunt of the adjustment.

The lifetime employment system was developed by large firms during the high-growth reconstruction era in response to the shortage of skilled labor. Companies hired fresh college graduates at relatively modest wages and invested a great deal in training them, knowing they were unlikely to leave the company both because their specialized skills would not transfer easily and because mid-career hiring was extremely rare. Employees had numerous incentives to support the system: advancement depended on seniority; promotions were practically assured regardless of performance; and a wide range of nonmonetary benefits accrued to loyal employees.

Small firms try to compensate for the lack of employment guarantees by treating their employees as a family. A willingness to provide nonmonetary benefits or additional money in times of personal need develops significant worker loyalty. While many American firms also follow this practice, it has a greater impact in Japan because group interactions play a central role in society. An interest in the employee's personal affairs is accepted as genuine concern in Japan, while it might be considered an invasion of privacy in this country.

Japanese labor unions have evolved from their American origins into unique creatures. Unlike the United States where industry-wide unions are common, unions are specific to one enterprise in Japan. Since the union's welfare is so intimately linked with the success of the company and not the entire industry, it is not surprising that close cooperation between union and management characterizes Japanese labor relations. These enterprise unions, however, often belong to a federation that covers one or more industries. The federations coordinate activities in cases where unity is necessary to achieve the unions' goals; they rarely direct the member unions. They are primarily active in wage negotiations and politics.

Enterprise unions negotiate annually with management on all non-wage areas, including working conditions, fringe benefits and company strategy. This allows each union to tailor its demands to specific situations. While this system is more flexible than the American method, it can also result in great variations in employment conditions among companies within the same industry.

Since 1955 enterprise unions and federations have pooled their resources in the annual nationwide spring wage negotiations known as shunto. Spring is the chosen season for three reasons: companies begin the process of hiring college graduates and must establish uniform entry-level wages for all categories of workers; many firms begin their business year in the spring, making it a natural time to adjust salaries; and since the Diet is usually debating fiscal policy for the coming year, labor tries to leverage its unity on wages for political advantage. Until 1981 each industry set its own wage demands based on that sector's economic prospects. Since then, however, the unions have promulgated uniform wage demands to reflect the overall economic situation, although a few industries have always set the pace. From 1962 until just recently, unions representing steel, electrical machinery, automotive and shipbuilding workers set the standard. Because of the difficulties facing the steel and shipbuilding sectors, the mantle of leadership has been passed to employees in the nonelectric machinery (including computers and consumer electronics), telecommunications and transportation industries.

Opposing the unions' stance is management's arm, the Japan Federation of Employers' Associations, or Nikkeiren. In response to the unions' initial proposal issued in December or January, Nikkeiren issues its report on the economic situation, including a counterproposal. Political maneuvering continues through March, real bargaining begins in April and settlements are concluded by the end of May.

Between the mid-1950s and the 1973 oil shock, the labor movement was usually politically quiescent. In response to the turmoil of the 1970s, however, the unions turned to politics to influence fiscal policy. Not surprisingly, their support went to the Socialist and Communist parties. The fact that the Liberal Democratic Party has been in power for more than three decades and is closely tied to business interests testifies to labor's weak political muscle. The challenges of the late 1980s threaten a more general enfeeblement of the labor movement.

The Challenges

A broad range of economic and social forces are buffeting Japan's workers and unions. In one sense, laborers are victims of their own success: hard work and close cooperation with management have pushed the economy rapidly through the reconstruction and into the post-industrial phase of development. In addition the highly competitive export machine Japan built now threatens to overload the global trading system and must be restructured. Economic maturity has created new pressures for social change as well, all of which will force labor to mend its traditional ways.

Shift to a post-industrial economy - Until the 1980s manufacturing's share of gross national product in real terms had been gradually declining while the service sector's share was rising. The export boom of 1980-85 temporarily reversed the shift toward a post-industrial economy, although the tertiary or service sector still accounted for nearly half of gross domestic product. Growth in the consumer and financial service areas is expected to easily outstrip manufacturing's performance in the coming decades, forcing labor to move from one sector to the other. This sectoral shift is already quite clear: while approximately 800,000 jobs were created in the manufacturing sector between 1980 and 1986, over 3.2 million workers entered non-manufacturing, non-agricultural positions (see Table 1). The shift presents a problem to workers in general and labor unions in particular.

Job skill requirements are obviously quite different in the manufacturing and service sectors. For workers in declining industries, retraining is a central issue. Not only is the availability of this training in question, but the worker's ability to fit into another slot is also a concern. Fishermen, for example, who are eligible to take advantage of government training programs are often unable or unwilling to enter a new profession. Although manufacturing workers are generally better educated, their willingness to discard old skills is also unclear.

The shift has struck particularly hard at areas that have traditionally been centers of union strength -- such as steel, shipbuilding and electrical machinery industries. Nippon Steel Corp.'s decision to close several facilities and cut its workforce significantly shattered the complacent attitude of many workers. Conversely, many service industries are generally non-unionized or present difficult organizational tasks -- for example the high-paying positions in financial services. The end result has been an erosion of union membership (see Table 2) and a scramble by leadership to reverse the trend.

Table 1: Distribution of Japan's Labor Force

(thousands of workers)

	<u>1965</u>	<u>1970</u>	<u>1975</u>	<u>1980</u>	<u>1981</u>	<u>1982</u>	<u>1983</u>	<u>1984</u>	<u>1985</u>	<u>1986</u>
Agriculture and Forestry	11,126	9,540	6,879	5,320	5,100	5,020	4,850	4,680	4,640	4,500
Fisheries	616	535	475	450	470	460	460	440	450	450
Mining	332	216	132	110	100	100	100	80	90	80
Construction	3,058	3,929	4,729	5,840	5,440	5,410	5,410	5,270	5,300	5,340
Manufacturing	11,511	13,682	13,236	13,670	13,850	13,800	14,060	14,380	14,530	14,440
Utilities	266	287	321	300	310	340	360	350	330	320
Transportation and Communications	2,843	3,214	3,365	3,500	3,440	3,490	3,500	3,410	3,430	3,530
Wholesale and Retail Trade	8,565	10,060	11,381	12,480	12,740	12,960	13,130	13,190	13,180	13,390
Finance, Real Estate and Insurance	1,164	1,377	1,755	1,910	2,000	2,060	2,130	2,160	2,170	2,225
Services	6,666	7,635	8,741	10,010	10,300	10,650	11,220	11,540	11,730	12,050
Government	1,456	1,720	1,595	1,990	1,940	1,950	1,950	1,950	1,990	1,970
Total	47,603	52,195	52,609	55,580	55,690	56,240	57,170	57,450	57,840	58,295

Source: Management and Coordination Agency

Table 2: Union Membership and Unionization Rate

(thousands of workers)

	<u>Membership</u>	<u>Change Over Previous Year</u>	<u>Share of Total Labor</u>
1965	10,147	3.5%	34.8%
1970	11,605	3.2	35.4
1975	12,590	-0.6	33.7
1980	12,369	0.5	30.8
1981	12,471	0.8	30.8
1982	12,526	0.4	30.5
1983	12,520	-0.0	39.7
1984	12,464	-0.4	29.1
1985	12,418	-0.4	28.9

Source: Ministry of Labor

An equally serious challenge is posed by the moderate economic growth characteristic of post-industrial development. High growth in the 1960s provided ample employment and promotion opportunities for all. Slower growth in the following decade still supported a promotion system based more on seniority than performance. Since 1980, however, the economic situation has put great pressure on the seniority system; cracks in the system are already becoming wider.

The most visible is the increasing number of mid-career job changes. Although the numbers are still very small compared to the United States (see Table 3), job mobility is on the rise, as indicated by the growing respectability of executive search firms. In fact, pressure for change is coming from both sides. Companies interested in paring employment but loathe to fire anyone have made job placement services available to their employees. Middle-aged workers with little chance of being assigned a job with real responsibility in the face of slower growth are opting for the challenge of a career change.

The high yen and economic restructuring - Accelerating the shift, the strong yen is forcing manufacturing companies to adopt new business strategies that include transferring or eliminating excess workers, moving production abroad, diversifying into new areas, forcing subcontractors to lower prices (read improve their efficiency), resisting wage increases even more fiercely, and using more part-time workers. Each of these presents workers and unions with a difficult choice -- whether to place the health of the company ahead of the interests of the individual workers.

Foreign investment and diversification are perhaps the trickiest issues. The first is acceptable to the unions as long as no domestic jobs are lost. Management, however, can often find its options closed. Nissan Motor Co., Ltd., for example, hoped to expand its manufacturing operations in Great Britain, but had to postpone this move when the Japanese union protested. Foreign manufacturing is even more important in view of the high yen, but unions are fighting to keep as much value-added in Japan as possible. Diversification is even trickier. Workers at Nippon Steel and the Japan Railways

group (the ex-Japanese National Railways) are finding it difficult to adjust to new jobs. Equally important, unions are having difficulty juggling the concerns of workers in the new subsidiaries with those of the old-line employees.

Table 3: Labor Turnover Ratio

	<u>Separation Rate</u>	<u>Retirement Rate</u>
1980	1.60%	1.10%
1981	1.60	1.00
1982	1.60	1.00
1983	1.60	1.00
1984	1.60	1.00
1985	1.60	1.00
1986	1.62	1.05
1987		
January	1.53	1.14
February	1.49	0.96
March	2.05	1.33
April	3.11	1.78
May	1.61	1.04
June	1.30	0.84
July	1.40	0.91
August	1.30	0.84
September	1.27	0.93
October	1.44	0.91

Source: Ministry of Labor

On the other hand the switch to domestic demand-oriented industries is creating new employment opportunities. The construction boom has brought new orders for inputs from related industries, as has the jump in public works projects. Even here, however, workers face the challenge of rapidly developing appropriate job skills.

Demographic changes - Japan's postwar baby boomers are now in the 30-to-40-year-old age group, enjoying the prime of life and forming a solid tax base for government social programs. By the turn of the century, however, this demographic bulge will be nearing retirement age. With a low birth rate (11.4 per thousand in 1986 versus 15.7 for the United States), not only will the tax base shrink but the need for government spending will increase. (Any decline in education outlays will be outweighed by increases in social security and medical programs.) Ad hoc solutions are appearing, most of which focus on putting retirees back to work.

One trend that has disturbed many Japanese is the increasing presence of illegal foreign workers. "Tourists" from South and Southeast Asia are taking low-level jobs in increasing numbers. The situation is similar to the American use of immigrant workers to harvest many agricultural crops. The wages may be low from a domestic worker's viewpoint, but they are well above what the foreign worker could earn at home. There are some signs that Tokyo may be reconsidering its adamant stand against foreign guest workers with an eye toward the

coming labor shortage. The greying of Japan poses thorny problems for policy-makers in Tokyo (see JEI Report No. 12A, March 27, 1987), but any solution will fail without the input and cooperation of workers and unions.

Changing social values - Although an American-style women's liberation movement stands little chance of taking root in Japan, the role of women in society is undergoing steady change. While they continue to form the bulk of the part-time workforce, women are also increasing their presence in the corporate mainstream. Thanks to a 1985 equal employment opportunity law, the government and many private firms have adopted policies to insure that women are represented more equally in hiring and promotion activities. On the other side of the coin, society is gradually accepting female business executives as a valid role model alongside the traditional housewife. Unions must respond to this change, which represents an opportunity to increase their membership.

Japan has developed an international reputation as a nation of frugal workaholics. Thanks to the yen's appreciation, per-capita income could approach the U.S. level in 1988. With the rise, however, more and more Japanese are asking why housing and social infrastructure (parks, roads, recreation facilities) standards are low compared with other developed nations. As part of its campaign to increase domestic demand, Tokyo is raising investment in public works and is encouraging people to enjoy themselves more by gradually moving the nation toward a 40-hour work week. (The average Japanese put in 46.7 hours in 1986.) This attitude revolution could have a significant long-term impact on labor productivity.

An adjunct to this trend is the increasing value put on more intimate and active family relations. This surfaces not only in increasing resistance to heavy overtime, but also in a reluctance to accept a job away from the family. A willingness to move has always served as one indication of company loyalty and in many cases is a necessary step up the corporate ladder. According to Labor Ministry surveys, however, as many as one-third of the working male population now disapprove of the practice. Some employees have even filed lawsuits claiming they suffered because they refused to move at the company's orders.

Liberalization, deregulation and privatization - Tokyo's drive to open goods and services markets to greater foreign participation is another dual-edged sword labor unions must handle. On one hand, foreign firms create new employment opportunities; on the other, they can disrupt traditional business and labor practices. Foreign firms have been a major force behind increasing job mobility. Financial firms in particular have been raided by foreign companies striving to quickly create a major presence in Japan. The surge in foreign investment in research and development facilities offers tempting opportunities for experienced scientists. The National Land Agency estimates that foreign firms will employ an estimated 60,000 more people by the end of this century, including many experienced workers. Tougher international competition may also lead to a long-term decline of some industries, but this will surely be balanced by the growth of others.

Deregulation and privatization have sparked solid growth in the financial and telecommunications industries at the expense of disrupting existing patterns of unionization and power. This in itself is not necessarily bad for

workers and labor unions, since new unions form and the balance of power between management and labor is maintained. It does, however, force unions and laborers to make adjustments that are sometimes painful but always wrenching.

The chaos that ensued when the Japanese National Railways was privatized is a perfect example. The five unions that represented employees when JNR was a government-owned company disintegrated in the face of stringent demands by the new private managers. Strikes and even sabotage marked the difficult adjustment period. While unions and workers can attempt to influence government policies, most of these forces are beyond their control. The challenges are new to postwar Japanese -- they cannot be solved by simply working harder. In searching for solutions, the Japanese are examining the experiences of other countries. Not surprisingly, the American model heads the list.

The U.S. Experience

In the early 1980s this country faced the same problems: a post-industrial shift, a high dollar and an aggressive government program of deregulation. The adjustment toward an economy driven mainly by service sector growth was already well under way by the beginning of the decade. The strong dollar, however, forced management to make abrupt changes. Crash programs to cut costs spread through manufacturing and service firms alike, with the axe falling hardest on labor. Manufacturing based on well-established technologies or with relatively low value-added moved offshore whenever possible, again with dire consequences for employment.

Japanese observers were highly critical of the American adjustment process, arguing that the U.S. economy was "hollowing out" and that the international competitiveness of American manufacturers was suffering. By indiscriminately paring workers, companies were damaging their ability to expand when the economy rebounded, it was said. The worsening of the adversarial relationship between management and labor was also criticized as contributing to the adjustment difficulties. Unreasonable management and labor demands only made the necessary changes more abrupt and painful, Japanese observers charged. The government's hands-off attitude was also deplored. Instead of greasing the wheels of economic adjustment with new retraining programs, or providing relocation assistance, the Reagan administration let the market apportion the costs of adjustment. The social costs of the resulting high unemployment were simply unacceptable from the Japanese viewpoint.

Japanese labor unions also took close note of how the pendulum of public opinion and management policy had swung against their American counterparts. Beginning with President Reagan's strike-breaking action against the air traffic controllers' union, national sentiment turned decidedly anti-union. Organized labor's most potent weapon, the strike, lost its efficacy as the swelling ranks of unemployed formed a willing replacement pool that management unhesitatingly tapped. No longer able to win wage hikes or assure job security, U.S. unions saw their membership begin to decline. In sum, organized labor emerged from the adjustment process significantly weaker, a situation Japanese labor leaders are working to avoid.

The Unions Respond

The keystone of Japanese labor's strategy is to continue to work closely with management to smooth out the adjustment process. By wisely acknowledging

that they cannot stop the changes, unions stand a better chance of exerting a positive influence on business and government policies. This does not mean that labor will be led meekly to the gallows. For example, in response to a Nippon Steel diversification plan, the Nippon Steel Workers Unions (Tekko Roren) states that "the proposals for the temporary suspension of the extension of retirement age, long-term education and layoff of aged workers [are] unavoidable," although "it is an unfavorable compromise in view of the effects on the target workers and the details of past negotiations." The federation has issued a full critique of Nippon Steel's proposal, seeking even greater commitments from the company (see Appendix A).

The annual wage negotiations are also being framed to correspond to current realities. It has already been noted that wage leadership has been passed to the high-growth industries, service or manufacturing, in an effort to raise the average settlement. If the past two years are any example, however, the tactic will fail. Wage settlements have been linked even more tightly to each industry's individual situation without regard to other sectors or to the economy as a whole. In fact, labor has lost a great deal of face in the past several years for settling for only half the raise initially proposed. The pattern will apparently repeat itself this year. The General Federation of Private Railway Workers' Unions of Japan (Shitetsu Soren) has asked for a 9.8 percent hike, while the new Japanese Private Sector Trade Union Confederation (Rengo) has announced that it will seek an average 7 percent increase. Nikkeiren will take the same stance it did in 1987, arguing austerity is necessary and offering no increase above the normal seniority wage hike.

This time around the unions are more interested in job security than pay raises, especially in declining industries. Although this goal has been the foundation of labor relations, workers took it for granted until recently. But any guarantee will exact a stiff price in terms of management's power to internationalize production and diversify domestic operations.

Measures to reverse declining membership are also at the forefront of union discussions. In moving to expand their non-work-related activities to lure new members, Japanese unions are following the same pattern as American unions. Recreational, educational and health services are all likely components. It is not at all clear, however, if these will be sufficient. Traditional labor organizing activities will be pursued, of course, but their effectiveness in the service sector is questionable. Organizing part-time workers is another possibility, but the problems here are even greater. The unions must find other ways to attract members; a serious possibility would be even greater activity in the political arena.

The November 20, 1987 inauguration of the Japanese Private Sector Trade Union Confederation, or Rengo, was hailed as a milestone for organized labor in Japan, much as the creation of the AFL-CIO in the United States. It is the largest federation in Japan with 5.55 million members drawn from Domei (Japanese Confederation of Labor), 1.52 million; Sohyo (General Council of Trade Unions), 1.22 million; Churitsu Roren (Federation of Independent Unions), 1.21 million; Shinsanbetsu (National Federation of Industrial Organizations), 600,000; and unaffiliated unions, 1.54 million. It also represents the broadest number of industries, with members from 55 industrial unions, one observer union and six associate unions. Unionized government workers, however, are not

included at present. The Socialist party-oriented Sohyo, which does include government employees among its 3.1 million members, has voted to merge with Rengo by 1990, which would make the federation a formidable force.

At its initial meeting Rengo set several goals:

- To aim for a "Western standard of living and not just a Western level of wages." This obviously includes social and working conditions as well as wages.

- To form a "dynamic industrial society by strengthening the economic and industrial base and promoting smooth structural adjustment of the industries."

- "To realize a rich welfare society through our demands for overall policy and institutional changes, working closely with think-tanks and coordinating specific policies of our own."

- To expand by including all unions and by organizing new workers.

- To promote the international trade union movement by recognizing Japan's role and responsibility in international society. This includes participating in the International Confederation of Free Trade Unions, the International Labor Organization and the Organization for Economic Cooperation and Development-Trade Union Advisory Committee. Support for Japanese official development assistance also falls under this category.

- To promote national peace movements.

- To promote equality of the sexes in employment and other areas, and

- To strengthen the collaboration between the union and the political parties.

Despite all the fanfare, many doubt that Rengo will have a major impact on the labor or political scene any time soon. Unless it can develop creative solutions to a multitude of problems, membership will continue to languish. On the political front, only by broadening its links to include the LDP can it ever hope to exert significant leverage. In sum, simply becoming bigger does not necessarily mean better.

Conclusion

To American ears the problems dogging Japanese labor today have a familiar ring: American workers and unions have grappled with an exodus of manufacturing plants seeking cheaper labor, with the threat of layoffs, and with the difficulties of job retraining or relocation. On the other side of the Pacific, however, these are new and jarring melodies.

Japanese workers have several attributes that will aid them in meeting the challenge and give them an advantage over their U.S. counterparts. In the past devotion to the economic health of the nation has proved a powerful tool to muster public support for painful policies. While it is weakening slightly, the work ethic also remains a potent force in Japan. Both will insure that the Japanese will avidly work to fulfill whatever solution is devised.

The cooperative relationship between labor and management is another powerful weapon that is already being brought to bear on the tasks at hand. This is the sharpest difference between the U.S. and Japanese labor environments -- one that has been reinforced in Japan by the painful experiences of American workers and unions. The long-term, company-centered vision of labor unions gives management much greater flexibility to implement adjustment plans.

A well-educated workforce is Japan's final ace in the hole. Japanese workers have already proved that the school system has prepared them well to use sophisticated equipment and quality control procedures. A solid educational base will make retraining efforts easier and possibly more successful.

On the other hand, the basic conservative nature of Japanese society presents a major hurdle to the psychological changes that are necessary. The Japanese must find a way to preserve the positive aspects of traditional attitudes while adding new ones. Unfortunately economic changes will almost certainly outpace attitudinal adjustments, putting great pressure on the societal harmony so highly prized in Japan. The challenges facing labor are great, but so are the weapons to combat them.

For further information, contact Jon Choy.

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The views expressed in this report are those of the author and do not necessarily represent those of the Japan Economic Institute.

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Takeshita Prepared For Washington

Prime Minister Noboru Takeshita has been busily preparing for his first trip to Washington as head of state January 12. As a matter of course, the preparations cover defense, foreign policy and economic matters, but Mr. Takeshita has painstakingly prepared his domestic audience as well as his foreign hosts.

Accompanied by Foreign Minister Sosuke Uno, the prime minister will spend three days each in the United States and Canada, returning home January 20 after stopping in Hawaii. Mr. Takeshita has a full itinerary planned for his Washington stay. On January 12 Mr. Uno meets with Secretary of State George Shultz. The prime minister's January 13 schedule includes a meeting with President Reagan, a ceremonial visit to the tomb of the unknown soldier, an afternoon discussion with House of Representative leaders, and a state dinner at the Japanese Embassy. On his final day the prime minister will deliver an address at the National Press Club and visit with Senate members before holding a press conference with the Japanese press.

new ideas. Agricultural issues could also pose thorny problems since farmers remain politically powerful and are adamantly opposed to further liberalization. The prime minister cannot go too far in supporting U.S. defense and foreign policies without risking a domestic backlash. During talks with opposition party leaders before leaving, Mr. Takeshita agreed that Japan will not over-extend itself in these areas.

Mr. Takeshita will have to prove himself to both domestic and foreign audiences. While his first trip abroad to attend a meeting of the Association of Southeast Asian Nations in December 1987 met with favorable reaction, the U.S.-Japan relationship is far more critical and sensitive. He may prove a disappointment to Americans if he maintains his image as a quiet, consensus-oriented and conservative politician. He may disappoint Japanese voters if he acts otherwise, however. The new prime minister must maintain a precarious balance, a position to which he is accustomed.

Jon Choy

Nervous Markets Push Yen Back Down

Just when it was beginning to look like betting against the U.S. currency was the safest gamble around, the inevitable happened: the dollar rose and the yen dropped. In the space of a few days in early January the yen gave up almost all of the gains it had made in December.

As 1988 opened few were forecasting a dollar rally, but once it had happened there were numerous explanations. Some experts said it was a technical correction. Others pointed out that many firms in need of dollars had sat on the sidelines, hoping to catch the dollar's bottom before making the purchases they would have to make eventually anyway. This theory suggested that once the dollar stopped dropping it would inevitably rise. Most intriguing, there were reports in Europe and Japan that the world's central bankers had a secret plan to keep exchange rates within fairly narrow bands. Consistent with this view, Tokyo, Washington and other governments reportedly continued intervening on the side of the dollar even after it started recovering, casting doubt on those who felt that all the central bankers and finance ministers wanted to do was slow the dollar's decline.

Still the dollar remains in one of its weakest positions ever. Last year was another rough one, as Table 1 illustrates. It was clear that the dollar could drop again on even the most trivial bad news. For the second time in a row it ended the year by hitting a new bottom.

The dollar's drop, which dates from early 1985, barely shows the effect of several well-publicized efforts to alter or stabilize its value. In September 1985 the Group of Five industrial nations met at the Plaza Hotel in New York. Their agreement that the dollar was overvalued now seems like a dramatic understatement.

In February 1987 the group, having added two members, met again in Paris and worked out what has become known as the Louvre Accord. This time the goal was to stabilize exchange rates. Japan and Germany agreed to stimulate their economies and the United States said it would cut its budget deficit. Japan

had just lowered the discount rate to 2.5 percent, where it remains; Germany followed with a later cut. Japan also implemented new government spending measures. Both steps have served to stimulate domestic demand, and the lower interest rates in Japan made U.S. investments attractive, thereby helping to sustain the value of the dollar.

Table 1: Yen-Dollar Exchange Rate, 1982-87

(monthly average, Tokyo interbank market)

	<u>1982</u>	<u>1983</u>	<u>1984</u>	<u>1985</u>	<u>1986</u>	<u>1987</u>
January	Y224.6	Y232.9	Y234.0	Y254.1	Y200.0	Y154.5
February	Y235.2	236.3	233.7	260.3	184.6	153.5
March	240.7	237.9	225.5	258.4	178.8	151.5
April	244.9	237.7	225.0	251.7	175.6	143.0
May	236.5	234.8	230.7	251.6	166.9	140.5
June	251.0	240.1	233.3	249.0	167.8	144.5
July	255.1	240.5	242.7	241.7	158.7	150.2
August	258.8	244.4	242.2	237.2	154.1	147.6
September	262.7	242.7	245.2	236.9	154.8	143.0
October	271.4	233.0	246.9	214.8	156.0	143.5
November	265.1	235.3	243.3	203.9	162.7	135.3
December	242.5	234.3	248.0	202.8	162.1	128.4
Annual Average	249.1	237.5	237.5	238.5	168.5	144.6

Despite general agreement that Japan has pursued an expansionary monetary and fiscal policy, officials in different countries have criticized both Bonn and Washington for doing too little. In any case the dollar dropped after the Louvre Accord, but then appeared to stabilize, as planned. There were reports over the summer that the central banks intervened to keep the dollar from rising more. Whether intended or not, higher interest rates here worked to support the dollar, as the prime rate, which had been dropping since early 1986, started moving up in April.

By early fall whatever was propping the dollar up began to fail. Higher interest rates in the United States and increasing intervention by the Bank of Japan in August, September and early October were not enough to support the dollar. After the October stock market crash here and abroad, itself partly a consequence of the dollar support actions, U.S. policy changed abruptly, as Washington now accepted what it had paid so dearly to try to prevent -- ever lower values for the currency. With the Louvre Accord apparently dead, the rest of the world had little choice but to go along.

In 1987 foreign exchange markets may have seemed calmer to the Japanese than to the Americans. While the yen generally appreciated against the currencies of Japan's major trading partners, its rise against the dollar was the most dramatic, as Table 2 shows. Generally the yen increased most against third currencies that are explicitly linked to the dollar (the Hong Kong dollar) or that are closely tied by trade (the Canadian dollar). Until it reversed direction late in the year, the yen fell against the British pound and the Taiwan dollar.

Table 2: Changes in the Yen Against Selected Currencies

(other currencies in terms of yen at the end of year)

	<u>1986</u>	<u>1987</u>	<u>Percent Change</u>
German mark	Y83.26	Y78.21	6.5%
British pound	239.41	233.86	2.4
Australian dollar	106.59	91.34	16.7
Canadian dollar	117.06	96.14	21.8
Korean won	0.19	0.16	18.8
Singapore dollar	73.94	62.34	18.6
Taiwan dollar	4.55	4.31	5.6
Hong Kong dollar	20.69	16.27	27.2
U.S. dollar	161.60	124.05	30.3

With so many having managed to lose so much money, the months after Black Monday have been marked by extreme nervousness in the currency markets. Because of the approaching presidential election, Washington is likely to continue to see a weak and declining dollar as a lesser evil than rising interest rates, higher taxes, or reduced government spending -- the perceived alternatives. While still trying to figure out the stock market crash, currency traders will soon have to focus on what seems like the distant future -- political leadership in Washington after November. It will be an exciting year.

Douglas Ostrom

European Community Lists U.S. Trade Barriers

In December the European Community published its third annual list of U.S. trade barriers, naming over 30 obstacles maintained by the United States. The list is a counterattack on the congressionally mandated National Trade Estimate compiled annually by the Office of the U.S. Trade Representative. The U.S. report was first published in 1985 in compliance with Section 303 of the 1984 Trade Act, which requires an annual account of the most important trade barriers affecting U.S. exports of goods and services, American investment abroad and intellectual property rights -- whether or not they are consistent with international trading rules (see JEI Report No. 43B, November 11, 1987).

Critics charge that the USTR's document ignores U.S. trade barriers, thereby presenting a misleading picture of American trade practices. In order to achieve a more accurate representation of the international trade scene, the EC published its first list of American barriers to EC exports in December 1985, just a few months after the first National Trade Estimate was released. "The purpose of the EC report is to make clear that trade practices which impede exports are not a unique problem faced only by U.S. exporters. EC exporters face similar problems when trading with the U.S.," the community's report charges.

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JAPANESE BANKS IN THE UNITED STATES

Summary

One of the signs of the deepening economic relationship between the United States and Japan is the increased presence of Japanese banks here. While still mostly concentrated in New York and California, many are increasing their activities in other parts of the country, reflecting the continued high volume of bilateral trade and the increasing number of transplanted Japanese companies in the United States.

While some see this incursion as yet another example of Japanese firms taking on and defeating their U.S. rivals, forfeiting American jobs in the process, the reality is quite different. The added number of Japanese-owned banking concerns does not necessarily imply competitive success since they may be serving different clients. Even if these entities win business away from U.S. banks, banking employment in this country will remain about the same, as Japanese banks hire more Americans to handle the new customers, although, of course, the profits would go to Japan.

Freer competition among financial institutions in both countries is another factor likely to increase the Japanese presence here, but it is also expected to make Japanese and American financial institutions more similar.

Growth of Japanese Banks in the United States

The data in Table 1 show the recent growth of Japanese bank branches overseas. About one-third of these are in the United States; Europe and Asia each have a 30 percent share and the rest of the world accounts for the

remainder. Table 2 shows that foreign-owned banks have dramatically increased their presence in the United States in recent years, although Japanese banks have become less dominant within that group.

Table 1: Growth of Overseas Branches of Japanese Banks

	<u>Number of</u>		<u>Assets</u> (in billions of dollars)
	<u>Banks</u>	<u>Offices</u>	
December 1983	24	168	\$81,068
December 1984	24	177	105,802
December 1985	25	189	120,179
December 1986	27	204	132,559
June 1987	29	216	130,481

Source: Bank of Japan, Economic Statistics Monthly

Table 2: Growth of Foreign Banks in the United States

(number of agencies, branches and subsidiaries)

	<u>Japanese Banks</u>	<u>All Foreign Banks</u>	<u>Japan's Share</u>
November 1972	28	101	27.8%
May 1978	59	269	21.9
December 1979	63	345	18.3
June 1981	69	384	18.0
May 1982	71	466	15.2
June 1983	75	537	14.0
June 1984	75	562	13.3
March 1986	84	623	13.5
June 1987	98	658	14.9

Source: Federal Reserve Board

Most Japanese banks begin their operations in Manhattan. The city's financial prominence is a lure for foreign banks and many of the smaller Japanese banks operate their only American office in that city. According to data from The Banker of March 1987, about 57 percent of the approximately 7,600 U.S. employees of Japan's bank branches, agencies and representative offices work in New York City.

The other large concentration of Japanese banks is in California. Twenty-three Japanese institutions have a banking presence there and five of the eleven largest banks in the state are Japanese. Californians, if not Americans generally, are not surprised to see Japanese banks in shopping centers

and other areas of retail activity. The largest Japanese-owned bank in the state, California First, ranks as the 77th largest in the United States, with \$5.7 billion in assets.

In one of the most dramatic expansions, Sanwa Bank, Ltd., one of the world's largest banks, acquired the California subsidiary of Lloyds Bank PLC in 1986. The purchase more than doubled the assets of its renamed subsidiary, Sanwa Bank California, which had been operating as Golden State Sanwa Bank. Assets increased to \$3.5 billion, earning Sanwa the ranking as the ninth-largest bank in the state. In 1991 nationwide banking comes to California and the Japanese banks operating there are likely to face substantially increased competition from domestic banks, driving profits down and raising the price of acquisitions.

Acquisitions have been an important means of expansion for Japanese banks, especially in California (see JEI Report No. 42A, November 2, 1984). The International Banking Act of 1978 and other regulatory changes have made it relatively easy for U.S. banks to compete with foreigners to buy domestic institutions, but with the yen at an all-time high, U.S. banks may still look cheap to the Japanese.

Outside of New York and California, Japanese banks are scarce. Only the District of Columbia and 11 other states have any Japanese bank presence at all: Hawaii, Washington, Oregon, Illinois, Texas, Massachusetts, Florida, Michigan, Kentucky and Georgia. Japanese banks have few retail banking offices even in those states. The fourth-largest state, Pennsylvania, has no Japanese banks even though it has two of the country's biggest cities, Pittsburgh and Philadelphia. Nor are there any in Cleveland, Cincinnati, Columbus or elsewhere in Ohio.

Organizational Forms for Foreign Banks

Setting up a bank is not like most businesses: the approval of federal, and perhaps state, banking authorities is required. Depending on the kind of business the bank plans, it may choose an organizational structure from the following categories.

If it primarily intends to collect information for its parent firm's domestic clients, or solicit business for offices elsewhere in the United States, it will opt for a representative office. These operations cannot make loans or take deposits but can give referrals. Usually representative offices are small with only a few employees. Some of the regional Japanese banks confine themselves to a representative office in New York.

If business proves brisk, the bank may expand its operations and open a branch or agency. These are much larger and may have several hundred employees in one location. Legally and administratively, branches and agencies belong more to the Japanese banking system than to this country's, although they are, of course, subject to U.S. law. Agencies cannot accept deposits or perform trust functions.

Should the Japanese banking company find that its American business expands, it may opt to open a subsidiary where the regulatory burden shifts perceptibly from Japan to the United States. Foreign banks combine subsidiaries,

branches, agencies and representative offices to provide a wider range of banking services than they could otherwise. A subsidiary, for example, might involve an agency in a deal with a customer if the client could benefit from the involvement of the parent bank's worldwide network. It is no surprise then that Mitsui Manufacturers Bank, a subsidiary of Mitsui Bank, Ltd., has an office in the same Los Angeles building as the Mitsui Bank agency. California First Bank, a subsidiary of the Bank of Tokyo, Ltd., even has a representative office in Tokyo partly to facilitate coordination with its parent.

Foreign banks operating here face the same regulations as American banks and can engage in the same businesses. This principle dates from the International Banking Act of 1978. Prior to that, foreign banks could engage in activities denied U.S. banks, including doing banking in more than one state. Since 1978 they have had to declare a home state in which they operate, although many foreign banks operate under grandfather clauses that permit them to continue interstate activities begun before 1978. Even without the International Banking Act the advantage of interstate operation would have diminished as domestic banks were granted increased interstate banking privileges.

Of the 27 Japanese institutions doing banking in the United States in early 1987, 17 chose California and 10 opted for New York as home states. Since many chose state, rather than federal charters, California and New York state banking officials have important roles in supervising and regulating them. California is popular partly because so much U.S.-Japanese trade flows through that state. Since subsidiaries are governed by U.S. law, they are able to do some things that would be illegal in Japan, although the Ministry of Finance has considerable leverage it can apply informally against Japanese banks.

Table 3 lists the Japanese banks doing business in the United States and how they are organized. Some Japanese banks that are not listed have representative offices here. For purposes of comparison, the largest U.S. banking organization, Citicorp, had worldwide assets of \$196 billion at the end of 1986. The Japanese bank with the largest presence here, Mitsubishi Bank, had \$246 billion in worldwide assets on March 31, 1987.

Why Do Japanese Banks Come Here

Japanese banks have been moving abroad for years to be close to major financial markets, but this shift picked up speed in the mid-1980s. Since New York and London have been vital global financial markets for some time, why the heightened interest?

One reason is Japan's capital market liberalization. Investment funds, once restricted, are now generally free to move into or out of Japan. Foreign firms, which were previously restricted from raising money in Japan, can increasingly do so directly or indirectly. Japanese interest rates, once set administratively, are more and more the result of market forces. These forces have served to link Japanese and overseas capital markets. A large Japanese borrower will not use his bank in Japan, despite generally higher interest rates abroad, if he gets a more attractive offer in New York or London. Even the local banks have to know what's going on in New York in order to be competitive. While they may have a relationship with one of the big nationwide commercial banks that plays in the New York money markets, that same bank may be a rival in the race for customers.

Table 3: Japanese Banks in the United States

(assets in thousands of dollars as of June 30, 1987)

	Agencies	Branches	Subsidiaries	Other	Total
Mitsubishi Bank, Ltd.	\$4,173,424	\$19,035,015	\$5,251,424	\$147,044	\$28,606,907
Dai-Ichi Kangyo Bank, Ltd.	4,761,698	21,356,788	229,638	--	26,348,124
Fuji Bank, Ltd.	4,924,974	16,342,575	3,955,815	9,182	25,232,546
Bank of Tokyo, Ltd.	1,371,778	12,660,213	10,258,572	24,533	24,315,096
Industrial Bank of Japan, Ltd.	3,396,308	8,647,968	6,588,810	65,256	18,698,342
Sanwa Bank, Ltd.	2,241,890	9,843,632	5,067,044	--	17,152,566
Sumitomo Bank, Ltd.	1,869,193	11,754,088	2,665,621	--	16,288,902
Tokai Bank, Ltd.	2,448,653	7,953,960	1,470,711	--	11,873,324
Mitsui Bank, Ltd.	1,417,264	6,709,570	1,817,647	--	9,944,481
Sumitomo Trust & Banking Co., Ltd.	1,710,254	6,973,306	--	--	8,683,560
Mitsui Trust & Banking Co., Ltd.	2,256,738	5,424,728	--	--	7,681,466
Taiyo Kobe Bank, Ltd.	1,192,001	6,072,204	--	--	7,264,205
Yasuda Trust & Banking Co., Ltd.	2,333,846	4,898,359	--	--	7,232,205
Mitsubishi Trust & Banking Corp.	2,484,043	4,518,287	144,373	--	7,146,703
Daiwa Bank, Ltd.	1,048,393	4,781,164	1,242,555	--	7,072,112
Long-Term Credit Bank of Japan, Ltd.	1,372,897	4,208,000	459,573	--	6,040,470
Norinchukin Bank, Ltd.	--	6,032,181	--	--	6,032,181
Kyowa Bank, Ltd.	1,503,843	3,462,174	93,099	--	5,059,116
Toyo Trust & Banking Co., Ltd.	1,460,566	3,393,234	--	--	4,853,800
Nippon Credit Bank, Ltd.	983,135	3,839,029	--	--	4,822,164
Bank of Yokohama, Ltd.	747,398	3,450,391	--	--	4,197,789
Hokkaido Takushoku Bank, Ltd.	666,748	2,873,844	--	--	3,540,592
Saitama Bank, Ltd.	--	3,112,004	--	--	3,112,004
Chuo Trust & Banking Co., Ltd.	--	2,471,689	--	--	2,471,689
Chiba Bank, Ltd.	--	2,279,274	--	--	2,279,274
Hokuriku Bank, Ltd.	--	1,295,241	--	--	1,295,241
Shizuoka Bank, Ltd.	--	1,144,250	--	--	1,144,250
Hyakufuji Bank, Ltd.	--	1,039,324	--	--	1,039,324
Shoko Chukin Bank, Ltd.	--	663,443	--	--	663,443
Hachijuni Bank, Ltd.	--	147,204	--	--	147,204
Total	44,365,044	186,383,139	39,244,882	246,015	270,239,080

Source: Federal Reserve Board, unpublished data.

Another reason is growth, both in the economy generally and in Japan's balance of payments. Japanese economic growth over the past 30 years has created financial assets and liabilities to match. It is inevitable that Japanese investors and borrowers would like to diversify. As the largest and best-developed financial system in the world, the United States cannot be ignored.

This rapidly increasing investor interest is reflected in Japan's balance of payments. While a current account surplus is usually interpreted to mean an excess of exports over imports, it is equally a deficiency of inbound compared to outbound investment. In fact the current account surplus is, in part, a reflection of the desire to invest abroad. Much of that investment has gone to the United States, as Table 4 shows.

Table 4: Japan's Long-Term Capital Flows, 1986

(in billions of dollars)

	<u>World</u>	<u>United States</u>
Net direct investment	\$14.3	\$7.8
Net securities investment	101.4	55.9
Net other long-term capital flow	15.8	1.9
Total	131.5	65.6

Source: Bank of Japan, Balance of Payments Monthly

Japanese banks are part of the process, making loans across national boundaries that are reflected in outbound capital flows and that may require a presence in the United States to solicit business and to arrange and monitor the loan. Japanese banks' interest in buying firms that are primary dealers in government securities, a controversial subject in Washington, reflects their customers' interest in those instruments. Foreign securities holdings of all Japanese banks in banking accounts and trust accounts have grown rapidly and are an increasing percentage of bank assets, reflecting the growth in the Japanese economy and moves toward international diversification.

The boom in investment in the United States reflects growing international activity. In 1985 Japanese banks passed U.S. banks for the first time in international lending and in 1986 their lead became commanding, as Table 5 shows. The position of Japanese banks was helped by an appreciating yen, where yen-based assets corresponded to a larger number of dollars.

As their activities grow, Japanese banks are expanding beyond New York and California. Mitsui Bank, for example, operates offices in New York, Los Angeles, Seattle, Chicago, Detroit, Houston, San Francisco, Atlanta and Lexington, Kentucky. While the rest of these cities are either big or on the West Coast, Lexington would appear to be a puzzle. It isn't. Lexington is a few miles from Georgetown, Kentucky, site of Toyota Motor Corp.'s almost completed car assembly plant. Moreover, many of Toyota's suppliers are building plants in the same general area.

Table 5: International Banking Assets

(in billions of dollars)

	<u>December 1985</u>	<u>December 1986</u>
Japan	\$706.7	\$1,117.7
United States	589.5	598.3
France	233.7	276.1
United Kingdom	192.2	211.7
West Germany	191.2	270.0

Source: Bank for International Settlements

Mitsui Bank has a close association with Toyota. While the Mitsui representative office in Lexington cannot do banking business, it can play an important role in lining up financing, making wire transfers, and negotiating local banking arrangements. In fact, Mitsui is one of four Japanese banks in Lexington, along with Sanwa Bank, Tokai Bank, Ltd. and the Bank of Tokyo Trust Co., the New York subsidiary of the Bank of Tokyo.

This example illustrates another powerful motive for Japanese banks to move to the United States: the presence of their Japanese customers. Traditionally, that has meant exporters. Arranging trade financing has been an important business. For instance, Mitsui Manufacturers Bank, a Mitsui Bank subsidiary, is one of the largest issuers of trade letters of credit in California despite its relatively small size. In some cases U.S. offices primarily serve those exporting to Japan. When the Japanese bought less in this country with the dollar high relative to the yen in early 1985, Japanese banks in Seattle that were heavily involved in exporting logs and lumber and grain found themselves with much less to do.

More recently, with the surge of direct investment in the United States, banks have followed their Japanese customers to the location of foreign investment. As the Toyota example suggests, this implies increased geographical dispersion throughout the United States. California, with its 1,000-plus subsidiaries of Japanese companies, is likely to continue to be particularly important, however.

As Toyota brought its suppliers, these smaller companies can also be expected to bring their own regional banks with them. The recent flurry of activity by regional banks establishing New York representative offices may represent not only a perception that capital markets are becoming international but the first step toward establishing more extensive U.S. operations outside New York.

A further reason Japanese banks come here is because the banking structure offers them new opportunities. For example, nationwide commercial banks (city banks) cannot engage in trust banking in Japan, but are free to offer these services in the United States. Most have established subsidiaries to do just that, serving the U.S. subsidiaries of Japanese firms and gaining valuable experience in the trust business. The experience should prove useful when, as is likely, the business is opened to them in Japan. More generally, the banks

profit from the experience in a comparatively deregulated banking market, which could prove vital as the home market is liberalized.

Finally, Japanese banks become part of the U.S. banking system and are entitled to the benefits it provides. By setting up operations here, Japanese banks have access to the Federal Reserve Board's discount window. As with other kinds of direct foreign investment, their presence is insurance against possible future restrictions imposed by Tokyo, Washington, or even London. Japanese banks can and do join all sorts of electronic domestic payment and information networks, including Fedwire, an important means of transferring domestic funds operated by the Federal Reserve.

What Do Japanese Banks Do Here?

When a Californian sees a sign for Sumitomo Bank of California he might wonder whether that bank wants to, and is legally able to, provide him with banking services. Are Japanese banks here to serve Japanese companies and individuals or are they available to American retail customers as well?

As already suggested the answer depends partly on the bank's form of organization. Agencies and branches are restricted in the banking services they can provide and representative offices cannot offer any banking services, but serve a variety of other functions. Sometimes, as in Lexington, they are located near their customers. Often they are listening posts for political and economic developments. Subsidiaries are another matter. Some are engaged in extensive retail banking, but often foreign banks, including Japanese, are less interested in serving relatively small depositors and borrowers than medium-size and large corporations. Some Japanese subsidiaries in California reflect an earlier period when foreign banks, restricted in setting up branches there, established subsidiaries to conduct international banking.

Subsidiaries are perhaps the most diverse in terms of their activities. Some serve mainly Japanese clients; others, Americans. Table 6 lists the subsidiaries of Japanese banks in the United States in order of assets. In a report on this subject in the early 1980s, Dai-Ichi Kangyo Bank of California said its clients were 60 percent American and 40 percent Japanese. Ninety percent of Tokai Bank of California's customers were non-Japanese. In general, bank officials estimated that about 10 percent of all their business involved Japanese clients. Some acquired subsidiaries continue their traditional business. Manufacturers Bank in Los Angeles, acquired by Mitsu Bank in 1981, has continued to be a specialist at lending to medium-size firms.

Generally, foreign banks specialize in wholesale banking in the United States. While most of their activity is still lending, especially to large corporations and to government, in recent years they have begun moving into other activities. One such area is the arcane world of standby letters of credit, where Japanese banks are prominent. Today many U.S. companies and local governments have found that they can save money by issuing securities directly to the public, rather than borrowing money from a bank or other financial institution. The buyers of these securities typically want some assurance that the issuer will not default. One way to provide this assurance is with a standby letter of credit, a promise to pay the holder of the security in the event the issuer defaults. In return for the risk the bank collects a fee. Of course, few security holders would value this standby letter of credit very highly if

Table 6: Subsidiaries of Japanese Banks in the United States
(assets in thousands of dollars as of June 30, 1987)

<u>Subsidiary</u>	<u>Parent</u>	<u>State</u>	<u>Assets</u>
California First Bank	Bank of Tokyo, Ltd.	California	\$5,699,514
Sanwa Bank California	Sanwa Bank, Ltd.	California	5,067,044
Bank of Tokyo Trust Co.	Bank of Tokyo, Ltd.	New York	4,559,058
Industrial Bank of Japan Trust Co.	Industrial Bank of Japan, Ltd.	New York	3,995,714
Fuji Bank & Trust Co.	Fuji Bank, Ltd.	New York	3,955,815
Bank of California	Mitsubishi Bank, Ltd.	California	3,760,907
Sumitomo Bank of California	Sumitomo Bank, Ltd.	California	2,665,621
IBJ Schroder Bank & Trust Co.	Industrial Bank of Japan, Ltd.	New York	2,593,096
Mitsui Manufacturers Bank	Mitsui Bank, Ltd.	California	1,817,647
Mitsubishi Bank of California	Mitsubishi Bank, Ltd.	California	1,490,517
Tokai Bank of California	Tokai Bank, Ltd.	California	1,470,711
Daiwa Bank Trust Co.	Daiwa Bank, Ltd.	New York	1,242,555
LTCB Trust Co.	Long-Term Credit Bank of Japan, Ltd.	New York	459,573
Dai-Ichi Kangyo Bank of California	Dai-Ichi Kangyo Bank, Ltd.	California	229,638
Mitsubishi Trust & Banking Corp. (U.S.A.)	Mitsubishi Trust	New York	144,373
Kyowa Bank of California	Kyowa Bank, Ltd.	California	93,099
Dai-Ichi Kangyo Trust Co.	Dai-Ichi Kangyo Bank, Ltd.	New York	0
Mitsui Finance Trust Co.	Mitsui Bank, Ltd.	New York	0
Tokai Trust Co.	Tokai Bank, Ltd.	New York	0
Mitsubishi Bank Trust Co. of New York	Mitsubishi Bank, Ltd.	New York	n.a.
Total			39,244,882

Source: Federal Reserve Board, unpublished data.

they had less confidence in the bank than they did in the issuer of the security; the bank in that instance brings little of value to the deal.

In recent years, as some U.S. banks have gotten into trouble, they have had a problem competing for this business. An extreme example was Continental Illinois Bank, which had a close brush with bankruptcy in 1984 and found its credibility in this business decline dramatically. The booming demand for letters of credit and a diminished ability by U.S. banks to provide them created a niche for Japanese banks, particularly with local governments. Generally highly regarded by credit rating agencies, Japanese banks' letters of credit were valuable. Their willingness to offer attractive terms won them business throughout the country. Sanwa Bank, for example, had commitments totaling \$3.5 billion at the end of 1986.

Competitive Factors

If a Japanese-owned bank should beat out an American bank for the business of say, the city of Chicago (as it did in one well-publicized incident), the effect is not the same as if Chicago were to buy Toyota trucks. In the latter case, the Japanese firm would do most of its work in Japan; in banking the work would be done in the Chicago and New York offices of the Japanese bank. When Americans buy banking services from a Japanese-owned bank they are providing business for the American banking system to almost the same degree as if they bought the services from a purely domestic bank, and the trade balance is scarcely affected.

Still, some might argue that the ownership of the bank matters. What are the prospects that a larger part of the American banking system will be Japanese-owned? Some factors clearly favor the Japanese. Japanese banks have traditionally been permitted to operate with lower ratios of capital to assets. If this ratio is low, a bank can make a bigger return on equity for any given margin that it earns on assets. For example, if it borrows money at 8 percent and relends it at 10 percent, its margin is 2 percent against assets if it has no other expenses. The 2 percent margin implies a higher return on equity if the level of equity relative to assets is lower. Alternatively, it could shave the margin on its loans and earn the same return on equity as a bank with a higher capital-equity ratio.

This advantage is less than it appears, though. New international agreements are likely to force Japanese banks into conformity with the same rules as U.S. banks, with both countries toughening their requirements (see JEI Report No. 47B, December 18, 1987). During the expected five-year transition to the new rules, Japanese banks will have less of an advantage than they might: low capital ratios can be expected to make them stay away from some risky deals that banks with higher capital ratios would welcome. High capital ratios not only reduce rates of profit, they also act as a cushion against bad loans.

Another advantage is implicit in the previous discussion. Japanese firms are used to dealing with Japanese banks. As Japanese manufacturing firms come here in greater numbers, Japanese banks will benefit too. While this might seem parochial, American firms moving abroad after World War II preferred U.S. banks and provided an important impetus for the banks to follow.

Then, too, Japanese banks are likely to benefit from a current account surplus in Japan's favor and a strong currency, which suggests that they are likely to continue to have the liquidity and be of a size relative to U.S. banks that makes it much easier to take on large commitments. Despite the efforts of American banks and securities firms, Japanese financial institutions are likely to continue to get most of the business of recycling Japanese surplus savings to the United States and elsewhere.

Japan's home market for financial services is, by most measures, the biggest outside the United States. For this reason alone the banks are likely to feel more comfortable in the United States than those foreign financial institutions with smaller domestic markets. As nationwide banking expands here, Japanese banks, which can operate nationwide at home, may be well positioned to exploit new opportunities.

Many have argued that Japanese firms in general have superior management compared to U.S. firms. They cite as examples transplant Japanese motor vehicle companies employing American workers that seem to be better in almost every way than American automotive companies. If this is true for banks as well, then U.S. banks could have a challenge on their hands, first in California where Japanese banks are well established, but later all over the country.

How Are They Doing?

If success is gauged by market share, whether assets or deposits, then Japanese banks have been successful; they are growing relative to American banks. There are reasons to believe, however, that such a measure misses the point in an important way. Bank size reflects financial power, not expertise in banking necessarily. Japanese financial power is obviously at an all-time high, so the capital flows and asset levels for Japanese banks are too. But bigger does not necessarily mean better.

There are indications that Japanese banks are not doing banking better than U.S. banks, at least not on American turf. Because foreign bank agencies and branches are legally part of the home office, little profit data are available. But studies of subsidiaries of foreign banks generally show that they are no more profitable than other U.S. banks, although there is evidence that the banks were less profitable than average before the foreign bank acquired them. Foreign bank ownership may be a way to bring laggard banks up to the average, but the studies hardly point to an overall superior performance by foreign banks in this country. In a few cases Japanese banking companies have had difficulty running their U.S. acquisitions, as Fuji Bank's purchase of Walter E. Heller's two commercial finance units in 1984 illustrates. Los Angeles-based Manufacturers Bank, as one of the most profitable banks in the entire country, was very attractive to Mitsui Bank. In 1986, however, the subsidiary suffered big losses and Mitsui had to make important management and operating changes.

Will Japanese banks be able to buy market share and later earn big profits, repeating a pattern apparently observed elsewhere? Or will Japanese banks be content with market share, never earning the profits Americans expect but still dominating the market?

The answer to the first question is no. The "market share now, profits later" argument assumes entry barriers that would prevent any firm from moving in to reap the high profits Japanese banks would presumably want eventually. There are thousands of banks in the United States, including a handful of giant super-regional banks, as well as increasing competition from non-bank financial institutions like American Express Co., brokerage houses and insurance companies. Japanese banks are unlikely to drive out enough existing competition or prevent the development of new competition.

As for the second query, Japanese banks will not be content with just developing and holding a large market share in the future, even if that was enough previously. The same factor that is driving them to the United States will work to make them more sensitive to profit concerns. As investors increasingly see the possibility of investing in markets anywhere, Japanese banks will compete with U.S. and European banks for the investor's favor. Increasingly, banks all over the world will be subject to the same investor criteria, and if it has been possible for Japanese banks to sacrifice profit for market share, it no longer will be.

The Future

The banking world continues to be in a state of flux. Deregulation is an ongoing process in both the United States and Japan, and the remaining regulations and supervisory practices are becoming more uniform. This suggests that in the future Japanese and American banks are likely to become more similar.

A major question on both sides of the Pacific is the separation between investment and commercial banking, currently mandated by Article 65 of the Securities and Exchange Law in Japan and the Glass-Steagall Act in the United States, which Congress is considering changing. While changes are being considered in both countries, Japanese and U.S. commercial banks are stretching existing restrictions on investment banking to the limit, sometimes using foreign locations in London and elsewhere to do some investment banking. The Industrial Bank of Japan, Ltd. has emerged as one of the world's leading underwriters of bonds in the Euromarket, even though it is very restricted in underwriting bonds in Japan and the United States. Sumitomo Bank Ltd.'s purchase of a stake in Goldman Sachs & Co., a leading American investment bank, also indicates an interest in this business, although Sumitomo has found its operational role very restricted. In one act Sumitomo managed to undermine the restrictions in both countries. On the one hand, as a bank operating in America, it bought part of an investment banker despite Glass-Steagall; on the other, it has an interest in a firm with a seat on the Tokyo Stock Exchange, thereby undermining Article 65. If existing laws remain intact, this kind of activity will increase.

There is a sense in both countries that Article 65 and Glass-Steagall will both eventually be significantly loosened or even repealed. When that happens, banks and securities companies will be able to invade each other's turf here and in Japan, as they do now in the Euromarket. Japanese banks have had limited success there, as Table 7 shows. Bond underwriting, an investment banking activity, is dominated by the investment banks, as expected. For the United States, commercial banks are represented on the list by Morgan Guaranty Trust Co. and Bankers Trust Co.; for Japan, by the Bank of Tokyo and the Industrial Bank of Japan. In 1986 Japanese banks had about 4 percent and U.S. banks about 9 percent of the Eurobond business.

Table 7: Leaders in the Eurobond Markets, 1986

(in millions of dollars)

	<u>Total</u>
Credit Suisse First Boston	\$122,757
Union Bank of Switzerland	99,016
Morgan Stanley and Co.	96,893
Swiss Bank Corp.	95,197
Nomura Securities Co., Ltd.	94,298
Merrill Lynch & Co.	89,190
Morgan Guaranty Trust Co.	88,407
Banque Bruxelles Lambert	87,004
Deutsche Bank AG	83,978
Warburg Securities	82,781
Daiwa Securities Co., Ltd.	82,658
Banque Nationale de Paris SA	80,186
Salomon Brothers Inc.	79,830
Banque Paribas SA	72,170
Goldman, Sachs & Co.	67,920
Orion Royal Bank, Ltd.	62,906
Nikko Securities Co., Ltd.	62,305
Bank of Tokyo, Ltd.	59,581
Dresdner Bank AG	59,025
Industrial Bank of Japan, Ltd.	56,570
Credit Lyonnais	56,039
Bankers Trust Co.	54,006
County Natwest Ltd.	53,904
Yamaichi Securities Co., Ltd.	53,493
Commerzbank AG	53,493

Source: Industrial Bank of Japan

Regardless of the fate of Glass-Steagall or Article 65, Japanese banks are likely to be important in the future of American banking. As the biggest banks in the world, occupying 12 of the top 20 positions in terms of assets (although not in profits), they could figure prominently in any large-scale bailouts in the U.S. financial services industry. Even though merger activity has slowed in the past few years, with the dollar at record low levels relative to the yen, U.S. banks and other financial service firms are likely to look attractive to Japanese banks.

For further information contact Douglas Ostrom.

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The views expressed in this report are those of the author and do not necessarily represent those of the Japan Economic Institute.

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Takeshita's Visit Calms Relations

Noboru Takeshita's first visit to Washington as prime minister January 12-15 went smoothly, reassuring observers on both sides of the Pacific that bilateral relations were in capable hands. Mr. Takeshita achieved his principal goal of initiating a solid personal friendship with President Reagan, leaving substantive talks for later negotiations. The visit was not completely without discord, however, as trade issues were inevitably discussed.

During their two-hour meeting, the president and the prime minister touched on all areas of bilateral relations, but paid particular attention to exchange rate stability and macroeconomic policy coordination. "A further decline of the dollar could be counterproductive," the two leaders warned, reiterating their commitment to the Group of Seven's December statement on exchange rates (see JEI Report No. 1B, January 8, 1988). To insure that the Federal Reserve Board would have adequate yen funds to support coordinated central bank intervention, the two leaders disclosed that a pact had been negotiated between the Bank of Japan and the Fed to swap up to \$5 billion for

that new food-labeling requirements in Japan constitute yet another agricultural import barrier. Furthermore, a group of 15 Democratic and Republican senators sent the prime minister a letter before his visit criticizing Tokyo's restrictions on rice imports.

Sen. John Danforth (R, Mo.), who is well known for his frustration with Japan's trade policies, also jumped on the critics' bandwagon. His grievance letter focused on the failure of Japanese motor vehicle exporters to raise their prices to accurately reflect the steep appreciation of the yen since September 1985. According to Sen. Danforth, "In the absence of responsible behavior on the part of Japanese automakers, it is inevitable that Japan will continue to face both intense pressure for a sharp reduction in the restraint level, and the very real threat of antidumping cases." He also listed several other market access issues involving fighter aircraft, silicon wafers, beef, public works construction and automotive parts.

Finally, House Asian and Pacific affairs subcommittee chairman Stephen Solarz (D, N.Y.) announced during a trip to Manila that he intends to visit Japan to discuss the possibility of a Japanese "mini Marshall Plan" for the Philippines. Mr. Solarz hopes to persuade Tokyo to initiate a program of grants, low-interest loans and investments as part of the policy of using economic assistance as Japan's contribution to international stability.

In short, the message seems to be that Congress wants further trade concessions and more Japanese initiatives to lighten the burden of American global responsibilities. The new prime minister is clearly prepared to put some issues on the bargaining tables, but in view of the lengthy list before him, he is bound to be wondering how much will be enough to satisfy Capitol Hill.

Eileen M. Doherty

Japanese Consumers Send Conflicting Signals

The Japanese, who rank among the world's greatest savers, are not yet the extravagant spenders some reports have concluded. While housing is booming, recent data reveal a mixed pattern for consumer spending, with some indicators pointing to a sharp rise while others hint at a contraction.

The growth of real gross national product in the July-September quarter was a strong 8.4 percent. While other components of domestic demand were up sharply, consumer spending lagged with an increase of 3.7 percent (see JEI Report No. 46B, December 11, 1987). Considering that consumer expenditures are partly the result of a multiplier effect from other public and private spending, this was a somewhat sluggish performance. Consumer outlays as a percentage of GNP fell from 56.4 percent in the April-June period to 55.8 percent in the year's third quarter.

Other data show a similar picture. Because consumer prices are rising slowly (up only 0.7 percent in November from the year before), these changes approximate real changes in spending. While department store sales show a healthy increase and car sales are generally higher despite some softness in

recent months, the broader measure of consumer spending is virtually unchanged from a year ago. This is not surprising in light of the small wage increases won over the past year (wages in November for all industries were up only 3 percent), but the numbers hardly suggest a spending spree.

Indicators of Consumer Spending*

	<u>Average Worker's Household Spending</u>	<u>Department Store Sales</u>	<u>New Car Registrations**</u>
January	1.2%	2.8%	260,721
February	2.2	4.9	268,550
March	1.2	4.6	264,558
April	0.6	4.6	244,788
May	2.4	7.0	260,468
June	-1.3	5.5	298,545
July	0.1	4.8	281,558
August	1.4	5.3	268,566
September	0.6	7.3	274,870
October	-0.1	6.0	296,936
November	n.a.	7.0	276,475
December (preliminary)	n.a.	n.a.	275,486

*Year-to-year change except as indicated.

**Seasonally adjusted.

Small wage increases are not the only reason, though. Consumers may be spending somewhat less of what they earn. Consumption averaged 81.4 percent of disposable income for the first nine months of 1987 compared to 82.1 percent for the year-earlier period. For all of 1986 this figure was 77.4 percent, the lowest level since 1978's ratio of 77 percent.

Douglas Ostrom

Congressional Outlook

When Congress reconvenes January 25 an extensive trade agenda will be waiting. Foremost among the items on that agenda is the pending omnibus trade bill, HR 3, which stalled last year in conference committee. Finance Committee chairman Lloyd Bentsen (D, Tex.) has indicated that he would like to see the conference committee agree on a bill by mid-March. But this scenario may be too optimistic. Some are predicting completion by early summer; others are beginning to consider the possibility that the bill may not get off the ground at all this year.

The uncertainty is already beginning to affect other trade issues. For example, the U.S.-Canada Free Trade Agreement is still awaiting a vote. Both the White House and the Canadian government would like to see it approved before legislators turn to HR 3. Canadian legislators, in fact, warn that Canada must be formally exempted from the provisions of the trade bill if the accord

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TRADE AND THE 100TH CONGRESS

Summary

Although the Democratic 100th Congress began with grandiose predictions that sweeping trade legislation would be a top priority, the trade proposals that were packaged as HR 3 ended 1987 stalled in conference committee. Nearly every major trade item has been postponed until the second session, although a handful of specific measures have been approved. Especially significant to Japan are two laws that affect trade in construction services and impose sanctions on Toshiba Corp. and its affiliates. This report will discuss the issues that are still awaiting action in 1988 and analyze those trade-related items that became law last year.

Status: Pending

The best summary of congressional action on trade issues during the first session of the 100th Congress is simple: still pending. Every major trade initiative that legislators considered during 1987 remains unfinished -- most obviously, the omnibus trade bill, which House Speaker Jim Wright (D, Tex.) and Senate Majority Leader Robert Byrd (D, W.Va.) had vowed to complete during the session. The bill's prospects appeared bright at the beginning of the year. The House passed HR 3 by the end of April; the Senate completed action in July.

The real holdup came at the conference committee stage. When the committee held its first organizational meeting in August, many observers still argued that the bill could be completed by the end of the year. Indeed, the

House and Senate leadership made it clear that they wanted to see a compromise by the end of October. But a number of factors combined to make the target unreachable. For example, every committee involved -- nine in the Senate and 14 in the House -- wanted the opportunity to name conferees to the committee. Their demands were especially important in light of several jurisdictional battles that were raging over trade issues. Mr. Wright and Mr. Byrd decided that the rights of these committees outweighed the advantages of simplicity and allowed each committee to participate in the conference. The result was a 199-member committee which, as it was too unwieldy, had to be subdivided into a convoluted system of 17 issue-specific subconferences.

Questions have been raised concerning Mr. Wright's motives in making this decision. Given the animosity between the Speaker and conference committee co-chairman Dan Rostenkowski (D, Ill.), some analysts have questioned whether he arranged the conference in a way that would undercut Mr. Rostenkowski's influence, since individual subconferences rather than the whole committee have the final word on their areas of negotiation. Others believe that the complex arrangement was designed so that the negotiations would continue well into 1988, thereby highlighting the issue in the presidential and congressional campaigns. Mr. Wright denies any ulterior motives. Whatever his reasons, the chairmen of the subconferences had trouble getting the negotiations off the ground. Only a handful of subconferences had met by the end of the year.

There were other reasons for the delay as well. As always, Congress' main preoccupation after the August recess involved fiscal matters. The tedious process of agreeing on FY 1988 appropriations and meeting the Gramm-Rudman-Hollings deficit target was enough to keep Congress busy until just before Christmas. Finally, many analysts suspect that the October 19 stock market crash was the coup de grace. Although spokesmen for the trade committees argued that a trade bill should calm shaky markets and that the crash would not affect the completion schedule, many legislators were extremely reluctant to pass legislation that is widely opposed on Wall Street and in global financial markets.

Conference committee chairmen -- Lloyd Bentsen (D, Tex.), head of the Senate Finance Committee and Ways and Means Committee chairman Rostenkowski -- hope to put a completed HR 3 on the president's desk by early spring, but others estimate that it may not be completed until the summer. There is even a possibility that the bill will not even get off the ground at all this year. (For a detailed discussion of the provisions of the House and Senate versions of HR 3, see JEI Report No. 36A, September 25, 1987.)

U.S.-Canada Free-Trade Pact

On January 2 President Reagan and Canadian Prime Minister Brian Mulroney signed a free-trade agreement that would (among other things) eliminate tariffs over the next 10 years on items shipped between the United States and Canada. The agreement, which is awaiting consideration by Congress and the Canadian Parliament, also includes a binding dispute resolution mechanism that overrides

national trade laws. Under U.S. law Congress has to consider the agreement on a "fast track" basis, that is, within a limited amount of time and without the right to amend the pact. Canada faces no similar requirement.

Approval of the free-trade agreement is by no means guaranteed since neither country's legislative body has indicated its wholehearted support. Given the increasing interest in protectionist legislation in the United States, it is somewhat ironic that the agreement appears to have a better chance of approval in Washington than in Ottawa. Legislators generally support the pact, especially since Canada is this country's most important trading partner.

On the specifics, however, they are cautious. Most have said that they want to study the agreement carefully before making a decision. And indeed, a few sore points have emerged. The automotive industry has expressed dissatisfaction with those elements of the agreement that affect trade in cars and trucks. Moreover, the constitutionality of the binding dispute resolution mechanism has been called into question by some Washington lawyers and may be subjected to greater scrutiny before Congress votes on the agreement. Finally, some legislators have complained that the White House should have allowed more congressional input on the FTA.

If there are reservations on the U.S. side, the objections are even greater in Canada. Parliamentarians have warned Congress that the FTA could run into serious trouble in Ottawa if Canada is not formally exempted from the provisions of HR 3. (They point out that Israel, which presently enjoys a free-trade agreement with the United States, is exempted under the language of the bill.) In addition to complaints of U.S. protectionism, there is a strong feeling in some business and government circles that the agreement is a threat to Canada's cultural sovereignty.

The White House has asked Congress to act promptly on the agreement, preferably before considering the omnibus trade bill. The request has fallen on deaf ears so far. Congressional leaders have announced their intention to finish work on HR 3 first. If the time limit under the fast track provision becomes a problem, legislators are apparently willing to consider attaching the free-trade agreement to the trade bill.

The fate of the pact is of significance not only to the United States and Canada but also to this country's relationship with Japan. Already there have been suggestions that a U.S.-Japan free-trade agreement would be a logical step if the pact with Canada is successful. In fact, during Prime Minister Noboru Takeshita's visit to Washington in mid-January, the Japanese leader agreed with Sen. Byrd to study the feasibility of a bilateral free-trade agreement patterned on the U.S.-Canada pact, although most observers believe this is premature. Not only are there certain barriers that neither country is willing to abandon, but the emotional overtones of U.S.-Japan trade frictions have created a congressional mood that is not conducive to such an agreement. Nor has the White House welcomed the suggestion with open arms.

Quotas On Textiles, Apparel and Footwear

The bill to impose stricter limits on imports of textiles, apparel and footwear may be pending in a technical sense, but most observers consider it

dead in the water for the remainder of the 100th Congress. HR 1560/S 549 is a revised version of the bill that passed the 99th Congress and was vetoed by the president. The proposal would establish global quotas based on 1986 import levels, a change from the 1985 bill, which targeted Asian countries and involved a rollback of imports (see JEI Report No. 8B, February 27, 1987.) Opponents of the proposal rejected not only the specifics of the bill but also questioned the need for tighter limits. They pointed out that the textile industry in particular is thriving (see JEI Report No. 19B, May 15, 1987). Since the House narrowly missed overriding the veto of the original bill in August 1986, the success of the new proposal depended not only on whether it passed but also whether it had enough congressional support to override another veto.

Consequently, when HR 1560 passed the House by a 263-156 vote September 16, analysts were quick to conclude that the results represented a defeat for the textile, apparel and footwear caucuses. The tally was 27 votes short of the two-thirds majority that is required to override. As a result, the Senate took no action on the bill. S 549 is on the Senate calendar for the second session and is expected to pass, but few observers believe that the proposal will survive the certain presidential veto.

One commentator recently noted that there always seems to be a textile bill before Congress. True. But since its supporters have said that they are by no means done fighting for tighter quotas, it is not likely that the issue will disappear anytime soon.

The Harmonized Code

On January 1, 1988 all the major trading nations but one implemented the Harmonized Commodity Description and Coding System, which is designed to simplify and integrate tariff schedules around the world. The United States was the sole exception. Although this country had signed the agreement, Congress failed to pass implementing legislation. The reason was simple. The legislation was included in the House and Senate trade bills. The House bill implements the new tariff classification system; the Senate version merely sets up a procedure for Congress to consider the code on a fast track basis.

When it became apparent that Congress would not finish work on the trade bill by the end of the year, some legislators suggested that the provisions on the new code be considered separately since U.S. participation in the new system is not a controversial issue. The idea was quickly squelched by legislative leaders, most notably Sen. Bentsen, who argued that doing so would begin the process of breaking up the bill. There was also an underlying current of fear that if the noncontroversial provisions were considered separately, not only would the provisions that remained in the bill lose congressional support, but the administration would no longer be under any pressure to sign HR 3.

Although the decision to keep HR 3 intact may have made good political sense for congressional leaders, it nonetheless constituted a minor embarrassment for American trade interests. The United States is now the only major trading country using a different system -- a system that is considered difficult to interpret and frustrating to use.

What Congress Passed

If legislators were unable to complete action on any of the major trade issues, they did not hesitate to attach a handful of trade provisions to other bills. A few of these will cause significant aggravation to Japanese industries; others are no more than minor headaches.

Construction Services - The administration's failure to win bidding rights for U.S. companies on the Kansai International Airport project has been an especially sore point in Congress. The issue was the most hotly discussed sectoral trade dispute on the Hill during the latter part of the year, and the adoption of a provision pressuring Japan to open its market to foreign architectural, engineering and construction companies was no surprise. Legislators attached a reciprocity amendment to the omnibus spending package (H J 395) that prohibits foreign firms from participating in federally financed public works projects if their government does not grant the same access to U.S. firms. The amendment does give the president a broad loophole to waive the prohibition if he decides that foreign participation would be in the public interest. (For a more detailed discussion of U.S.-Japan competition in construction services, see JEI Report No. 5A, February 6, 1987.)

Partly in response to this amendment a proposal was unveiled during Prime Minister Takeshita's January visit that would allow U.S. companies to bid on certain public works projects. The reaction in Washington was less than enthusiastic, both within the administration and on Capitol Hill. Secretary of State George Shultz and Foreign Minister Sosuke Uno did agree to working-level negotiations on the issue, but even that drew criticism from Sen. Frank Murkowski (R, Alaska), who charged that discussions have so far "got us nowhere." Sen. Murkowski has repeatedly urged the White House to initiate an unfair trade practices investigation under Section 301 of the Trade Act of 1974.

Toshiba Corp. - Most people expected Congress to be outraged that Toshiba Machine Co., Ltd. had illegally sold sophisticated milling machinery to the Soviet Union that gave the USSR the capability to build quieter submarines. But few Americans or Japanese were prepared to see a small group of congressmen take sledgehammers to Toshiba products on the Capitol grounds. Not only did that display receive international attention but it also gave observers an idea of the extent of the legislators' rage.

Nonetheless, the legislative fallout has been less than expected. A number of bills that lash out at both Toshiba Machine and its parent, Japan's second-largest electric machinery maker, have been introduced since the disclosures last summer. One of the most stringent, which would ban imports from both firms for two to five years, has been included in the Senate version of the omnibus trade bill. None had been enacted into law, however, until the passage of the deficit reduction bill (HR 3545). That bill includes a provision that prohibits the Defense Department from buying products from parent Toshiba or its subsidiaries, and forbids the sale of Toshiba goods at U.S. post exchanges throughout the world.

The Ministry of International Trade and Industry criticized the provision harshly and announced that it would file a formal protest with the White House. MITI said that the decision is a violation of Japan's independence since it ignores the fact that Tokyo has already enacted laws to punish the offenders and to tighten the enforcement of Japan's export control mechanisms.

While there is no doubt that the ban is a blow to the Toshiba Group, its enactment may forestall the adoption of more severe measures. As the end of the first session approached, the momentum on Capitol Hill to avenge the illegal sales was waning -- partially because a number of important U.S. corporations warned Congress that they depended on Toshiba parts for their products. Few observers think that Congress will forget the incident entirely, but now that some action has been taken Japanese businessmen are hoping that other pending proposals, including the provision in the trade bill, may be toned down or dropped. Nonetheless, some legislators, including Sen. Jake Garn (R, Utah), are still determined to include more punitive measures in HR 3.

Another repercussion of the Toshiba scandal involves the proposed changes in the U.S. export control law. The House version of HR 3, which aims for a 40 percent reduction in the number of items on the export control list and limits Department of Defense review of license requests, may simply be indefensible at this point. Given the publicity surrounding the administration's demands for tighter international control of exports to communist countries, it will be difficult to defend a large-scale liberalization scheme. And although House Foreign Affairs international economic policy and trade subcommittee chairman Don Bonker (D, Wash.) insists that his committee's liberalization plan is completely separate from problems surrounding illegal diversions, most conferees see a clear link. In short, although all agree that simplification of the export control list is desirable, the Toshiba scandal may lead conferees to adopt a very conservative approach.

U.S.-Japan Nuclear Pact - After some five years of negotiations, the United States and Japan initialed an agreement in November granting Japan a 30-year permit to ship nuclear fuel purchased from the United States to other countries for reprocessing and to transport the reprocessed product by air back to Japan. At present, permission is needed on a case-by-case basis. Approval has never been granted for an airlift, although the United States did allow the shipping of plutonium in 1984 -- with a U.S. naval escort.

No sooner had legislators begun consideration of the treaty, however, than it ran into trouble. The Senate Foreign Relations Committee decided in a bipartisan vote to send the treaty back for renegotiation because of environmental, health and political concerns. Critics pointed out that Japan has yet to develop a fuel container that would withstand the impact of a plane crash. This concern was especially worrisome to legislators who represent Alaska and other northwestern states since Japanese airlifts would fly over those areas. Furthermore, there were concerns that non-proliferation goals could be jeopardized since Tokyo has not provided a detailed plan of safeguards against diversions of nuclear materials from Japanese plants to other countries. Over 20 members of the House Foreign Affairs Committee signed a letter to the administration echoing these objections. In a similar move, legislators attached a provision to the budget reconciliation package to prohibit airlifts of plutonium over U.S. territory unless the Nuclear Regulatory Commission has certified to Congress that the plutonium container will not break if dropped from an airplane's maximum cruising altitude.

Strategic Defense Initiative - Legislators tacked a "buy America" amendment concerning Strategic Defense Initiative projects to the Defense Authorization bill (HR 1748). The provision prohibits the Defense Department from granting contracts for research, development, testing, or evaluation of SDI-related projects to a foreign government or firm as long as a domestic company is competent to carry out the terms of the contract. An exception would be

made if the foreign firm or its government pledges to underwrite "a substantial portion of the total contract cost." The bill's report language stresses that legislators will keep a close eye on the terms of this exception to insure that the "substantial" contribution does not end up amounting to only a fraction of total contract costs.

The SDI amendment, which was the brainchild of Rep. Les AuCoin (D, Ore.), is partially a result of congressional anger at what legislators believe is an administration attempt to buy international support for SDI through promises of profitable contracts. Mr. AuCoin said that the purpose of the proposal is to maximize the chances that "any jobs produced by SDI technology and by SDI research should go to Americans first." Supporter Pat Williams (D, Mont.) concurred and argued that the initiative is also designed "to stop the United States from becoming involved in international pork-barreling" (see JEI Report No. 21B, June 5, 1987).

Compact Trucks - This "buy America" provision takes aim at DOD's 1986 contract with Mitsubishi Heavy Industries, Ltd. for over 3,000 compact pickup trucks. The Defense Authorization bill contains a provision sponsored by Michigan Democrat Dennis Hertel that prohibits DOD from purchasing "administrative motor vehicles" manufactured outside the United States or Canada during fiscal years 1988 and 1989 unless the contract is for less than \$50,000 or is specifically authorized by law. Certain further exceptions apply to vehicles for use outside the United States. Mr. Hertel defended his proposal by saying that the United States is already subsidizing Japan's defense and the Pentagon should not be allowed to buy Japanese vehicles when so many American auto workers are unemployed.

Japanese Foreign Aid - Another amendment to the same bill concerns Tokyo's use of economic assistance as its primary contribution to international stability. Since most legislators are well aware of the political difficulties associated with U.S. demands for increased Japanese defense spending, the proposal praises Tokyo for the strides it has made in raising defense expenditures and implicitly acknowledges the validity of using foreign aid as a substitute for defense contributions. But the amendment outlines a five-point agenda that constitutes a "politically acceptable and significant global security role consistent with [Japan's] economic status."

First, the proposal suggests an increase in development assistance programs and defense spending so that the ratio of outlays to Japan's gross national product is roughly equal to those of other members of the North Atlantic Treaty Organization. Sen. John McCain (R, Ariz.) has estimated that in 1985 Japan's spending in these categories was only ahead of Luxembourg's; all other NATO members spent more than Tokyo's 1.29 percent of GNP (see Table).

The other four elements of this "sense of the Congress" amendment cover areas that Japan is already taking steps to accomplish. They are: (1) increasing aid to countries that are vital to global stability -- with a greater priority on non-Asian countries -- including such strategic areas as the Philippines and countries in Oceania, Latin America, the Caribbean and the Mediterranean; (2) increasing funds for untied grants and other concessional aid, as well as raising contributions to multilateral financial institutions; (3) pinpointing those countries that will receive increased aid through consultations with Japan's security partners; and (4) "further enhancing" Tokyo's pledge to contribute to global security after completing its FY 1986-FY 1990 defense program.

Defense and Foreign Aid as a Percentage of GNP*

<u>NATO Nations and Japan</u>	<u>Defense</u>	<u>Foreign Aid</u>	<u>Total</u>
United States	6.9%	0.24%	7.14%
Greece	7.1	--	7.1
United Kingdom	5.2	0.34	5.54
France	4.1	0.78	4.88
Turkey	4.5	--	4.5
Norway	3.3	1.03	4.33
Netherlands	3.1	0.91	4.01
West Germany**	3.2	0.47	3.67
Belgium	3.0	0.54	3.54
Portugal	3.1	--	3.1
Italy	2.7	0.31	3.01
Denmark	2.2	0.80	3.0
Spain	2.9	--	2.9
Canada	2.2	0.49	2.69
Japan***	1.0	0.29	1.29
Luxembourg	1.1	--	1.1

*Figures do not include security assistance.

**Does not include U.S. forces in West Berlin.

***Japan's defense figures exclude certain items, especially military pensions, that are included in NATO country figures.

Source: Office of Sen. John McCain. Derived from Department of Defense, Report on Allied Contributions to the Common Defense and Organization for Economic Cooperation and Development, Development Cooperation.

This amendment is far less objectionable to Japan than the original Senate proposal. Rather than suggesting that Japan increase foreign aid and defense spending to a level roughly equal with other NATO members, the original proposal called on Tokyo to boost aid expenditures to 3 percent of GNP by 1992, regardless of any increases in defense expenditures. (Japan's ODA/GNP ratio was 0.29 percent in 1986.) Finance Minister Kiichi Miyazawa expressed his anger at the proposal since it came in the midst of implementing a \$30 billion Japanese initiative for developing countries (see JEI Report No. 41A, October 30, 1987).

Japan's Trade With Vietnam - Yet another addition to the Defense Authorization bill calls on Japan to reduce its economic ties with Vietnam. Sen. Robert Kasten's (R, Wis.) resolution establishes a congressional finding that Japan's trade with Vietnam has expanded steadily since 1982. The amendment encourages Japan to continue denying economic assistance to Vietnam; refrain from giving Vietnam any type of trade financing or private financing; and continue to discourage Japanese exports of goods and technology to Vietnam. It urges Japan to especially discourage sales of equipment that enhance (1) oil exploration and development projects, (2) forestry and fishery production, (3) production of commodities for light industries and (4) export capacity.

Ministry of Foreign Affairs spokesmen have pointed out that in yen terms, Japan's trade with Vietnam actually decreased in 1986. Two-way trade did

expand during the 1983-85 period, but the 1986 figure fell 9.6 percent from a year earlier. But since the Senate cited trade figures in dollar terms, its results are different, showing 1986 trade with Vietnam up 27.2 percent as the yen appreciated 26 percent over the course of the year.

A Look Ahead

When Congress reconvened January 25 legislators faced a full trade agenda. Issues such as the omnibus trade bill, the U.S.-Canada free-trade agreement and the harmonized code top the list. Sectoral issues are also likely to remain at the forefront, including the textile-apparel-footwear bill and a number of specific U.S.-Japan trade issues. Market access problems in construction services and agriculture will continue to be a major concern on Capitol Hill. Of particular importance to Western legislators will be Japan's decision on liberalizing beef and citrus quotas on April 1. And an announcement as to whether Japan will continue to limit its car exports to this country and at what level is anxiously awaited on Capitol Hill.

The fate of HR 3 is contingent upon a variety of factors: other agenda items, the country's economic health, legislators' perceptions of constituent attitudes and administration-Capitol Hill relations, and internal political battles in Congress. And although predictions about the bill are rampant in Washington, these fall into three major categories. First, the administration-Congress cooperation may solidify into a constructive working pattern, which would produce a moderate bill that eliminates the most objectionable provisions of the House and Senate versions -- a scenario quite similar to the trade legislation that emerged in 1984.

Second, the political motives and protectionist rhetoric that have influenced the trade debate could gain the upper hand, resulting in a bill that combines the harshest elements of both proposals. The White House has pledged to veto this type of trade bill, and the likelihood of a veto override appears dim. Finally, the conference committee may agree on moderate legislation that nonetheless has a few elements that are unpalatable to the administration, for example, plant closing notification. If the president vetoes the bill on the basis of one objectionable provision (as he has threatened to do), congressional trade leaders would stand a good chance of leading a successful override.

It is almost inevitable that economic issues will be even more highly politicized than usual during an election year. But the health of the national economy may be no less important than politics in determining whether HR 3 will become a moderate or harsh law, or even whether it will die this year. If the economy remains uncertain -- hovering on the edge of a recession -- legislators on both sides of the aisle could easily decide that a radical trade bill may not be the wisest course to follow at present. Too, the wobbly nature of the markets since the October 19 crash is certain to make lawmakers keep a wary eye on economic indicators -- not least of which are the trade statistics.

For further information, contact Eileen M. Doherty.

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The views expressed in this report are those of the author and do not necessarily reflect those of the Japan Economic Institute.

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JEI

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Tokyo Works On New Economic Plan

In what has become a tradition, the Japanese government is developing a new medium-term economic plan even though the previous one still has two years to run. The current plan, adopted by the Nakasone cabinet August 12, 1983, called for 4 percent real annual growth through March 1991. Incredibly, the actual rate has been 3.95 percent for the first four fiscal years. Such accuracy, far better than in previous plans, would appear to suggest rigorous implementation. In fact, Tokyo does little to explicitly assure that its goals are achieved.

Japan's Trade Account Reverses Course

Although Japan's huge trade surplus peaked in dollar terms last spring, few economists, whether in the government or outside, expected the full-year 1987 figure to come in far enough below 1986's record \$82.7 billion number to take the heat off Tokyo in Washington and other world capitals. Their caution was justified. The yen's continued appreciation and stronger domestic demand did trim the surplus last year -- the first drop since 1982, but exports still topped imports by \$79.8 billion.

Caution also permeates forecasts of Japan's 1988 trade results, although there is universal agreement that the surplus will shrink again. On the plus side, all signs point to a continuation of 1987's strong import performance. Capped by a jump of one-third-plus in the October-December period, purchases from abroad climbed 18.2 percent last year to a new high of \$149.4 billion. This was not just a paper increase. Imports in volume terms continued to build on their 1986 gain of 13.3 percent, rising by an additional 7.4 percent, even though deliveries of crude oil, which make up more than one-third of the quantity index, were down by another 2.2 percent. But the clearest proof that the higher yen has changed purchasing patterns in Japan was the bigger volume of foreign manufactured products -- up by nearly 10 percent in 1987 on top of a 24.4 percent advance the year before.

Change in Volume of Japan's Exports and Imports

	<u>Exports</u>	<u>Imports</u>
1983	8.7%	1.3%
1984	15.4	10.7
1985	4.7	0.2
1986	-1.4	13.3
1987	-1.7	7.4
1985: I	6.9	0.6
II	6.8	-0.4
III	4.0	-2.8
IV	1.8	3.3
1986: I	-0.2	3.6
II	-0.9	16.8
III	-0.3	18.7
IV	-4.2	14.4
1987: I	-0.1	8.1
II	-3.9	3.6
III	-2.9	6.7
IV	0.0	11.3

A further slowdown in the growth of Japan's overseas sales should also help to rein in the 1988 dollar-denominated surplus, but most trade analysts are reluctant to predict much more than that given last year's export results.

Japan's Total Trade in Dollar Terms

(in millions of dollars)

	<u>Exports</u> (f.o.b.)	<u>Change Over</u> <u>Year-Earlier</u> <u>Period</u>	<u>Imports</u> (c.i.f.)	<u>Change Over</u> <u>Year-Earlier</u> <u>Period</u>	<u>Trade</u> <u>Balance</u>
1983	\$146,928	5.8%	\$126,393	-4.2%	\$20,534
1984	170,114	15.8	136,503	8.0	33,611
1985	175,638	3.2	129,539	-5.1	46,099
1986	209,151	19.1	126,408	-2.4	82,743
1987	229,228	9.6	149,395	18.2	79,833
1985: I	38,503	-1.3	32,513	-5.7	5,991
II	43,748	0.6	32,094	-7.0	11,654
III	43,909	2.7	31,239	-8.1	12,671
IV	49,478	10.3	33,693	0.5	15,785
1986: I	45,499	18.2	33,005	1.5	12,494
II	53,166	21.5	31,424	-2.1	21,742
III	54,768	24.7	30,153	-3.5	24,615
IV	55,718	12.6	31,826	-5.5	23,892
1987: I	51,478	13.1	31,940	-3.2	19,539
II	56,946	7.1	36,357	15.7	20,589
III	57,871	5.7	38,328	27.1	19,543
IV	62,933	12.9	42,770	34.4	20,163

Japan's Total Trade in Yen Terms

(in billions of yen)

	<u>Exports</u> (f.o.b.)	<u>Change Over</u> <u>Year-Earlier</u> <u>Period</u>	<u>Imports</u> (c.i.f.)	<u>Change Over</u> <u>Year-Earlier</u> <u>Period</u>	<u>Trade</u> <u>Balance</u>
1983	¥34,909	1.4%	¥30,014	-8.1%	¥4,895
1984	40,325	15.5	32,321	7.7	8,004
1985	41,956	4.0	31,085	-3.8	10,871
1986	35,290	-15.9	21,551	-30.7	13,739
1987	33,317	-5.6	21,720	0.8	11,597
1985: I	9,898	9.5	8,340	4.3	1,559
II	11,025	11.1	8,093	2.8	2,932
III	10,591	2.4	7,534	-8.3	3,057
IV	10,442	-5.3	7,118	-13.6	3,323
1986: I	8,674	-12.4	6,334	-24.1	2,339
II	9,119	-17.3	5,399	-33.3	3,720
III	8,632	-18.5	4,758	-36.8	3,874
IV	8,865	-15.1	5,060	-28.9	3,806
1987: I	7,962	-8.2	4,953	-21.8	3,010
II	8,156	-10.6	5,204	-3.6	2,952
III	8,510	-1.4	5,641	18.6	2,869
IV	8,689	-2.0	5,922	17.0	2,767

Japan's Trade with the United States in Dollar Terms

(in millions of dollars)

	<u>Exports</u> (f.o.b.)	<u>Change Over</u> <u>Year-Earlier</u> <u>Period</u>	<u>Imports</u> (c.i.f.)	<u>Change Over</u> <u>Year-Earlier</u> <u>Period</u>	<u>Trade</u> <u>Balance</u>
1983	\$42,829	17.9%	\$24,648	1.9%	\$18,181
1984	59,937	39.9	26,862	9.0	33,075
1985	65,278	8.9	25,793	-4.0	39,485
1986	80,456	23.3	29,054	12.6	51,401
1987	83,580	3.9	31,442	8.2	52,138
1985: I	13,346	6.8	6,771	1.3	6,575
II	16,837	9.0	6,641	-1.6	10,196
III	16,615	5.4	6,111	-9.8	10,504
IV	18,480	13.9	6,270	-5.7	12,211
1986: I	16,696	25.1	6,278	-7.3	10,418
II	20,921	24.3	8,305	25.1	12,616
III	21,280	28.1	7,525	23.1	13,755
IV	21,559	16.7	6,946	10.8	14,613
1987: I	18,003	7.8	6,961	10.9	11,041
II	21,187	1.3	7,589	-8.6	13,599
III	21,635	1.7	8,245	9.6	13,390
IV	22,755	5.5	8,649	24.5	14,107

Japan's Trade with the United States in Yen Terms

(in billions of yen)

	<u>Exports</u> (f.o.b.)	<u>Change Over</u> <u>Year-Earlier</u> <u>Period</u>	<u>Imports</u> (c.i.f.)	<u>Change Over</u> <u>Year-Earlier</u> <u>Period</u>	<u>Trade</u> <u>Balance</u>
1983	¥10,179	12.9%	¥5,855	-2.3%	¥4,323
1984	14,221	39.7	6,364	8.7	7,858
1985	15,583	9.6	6,213	-2.4	9,369
1986	13,564	-13.0	4,918	-20.9	8,646
1987	12,148	-10.4	4,575	-7.0	7,573
1985: I	3,429	18.3	1,737	11.9	1,692
II	4,244	20.4	1,674	8.8	2,569
III	4,008	5.2	1,474	-10.0	2,534
IV	3,903	-2.1	1,328	-18.7	2,575
1986: I	3,191	-6.9	1,203	-30.7	1,988
II	3,589	-15.4	1,421	-15.1	2,168
III	3,355	-16.3	1,190	-19.3	2,165
IV	3,429	-12.1	1,104	-16.9	2,325
1987: I	2,786	-12.7	1,080	-10.3	1,707
II	3,035	-15.4	1,085	-23.6	1,950
III	3,181	-5.2	1,214	2.0	1,967
IV	3,146	-8.2	1,197	8.4	1,950

Held down by a 1.7 percent drop in shipments, exports expanded by 9.6 percent in 1987 to \$229.2 billion -- half of the year-earlier rate. But the cutback in volume terms was surprisingly modest, especially since deliveries had dipped by only 1.4 percent in 1986. Even more puzzling was the fact that fourth-quarter shipments were no lower than the comparable 1986 figure. This suggests that Japanese exporters can live with an exchange rate of 140 or 130 yen to the dollar.

Susan MacKnight

Notes

Fishing Update - The United States and Japan appear to be on a collision course over Japanese research whaling activities. On January 20 Commerce Secretary William Verity warned the Japanese Embassy that the taking of any whales for research purposes before the International Whaling Commission had completed voting on the issue would be considered a violation of U.S. fishing laws. A Japanese expedition is en route to the Antarctic to take as many as 300 Minke whales as part of a "comprehensive assessment" of the global whale population, as called for under a section of the IWC charter. Britain, however, submitted a resolution asking Japan to stop research whaling, but voting will not be completed until February 14.

U.S. conservation groups threw their weight behind the whales. Sixteen associations filed suit January 13 in U.S. District Court for the District of Columbia claiming that Japan's research whaling program is a smokescreen for continued commercial whaling. They argue that the research activities violate the 1982 IWC moratorium on whaling, reducing the IWC's effectiveness and triggering U.S. sanctions. Mr. Verity warned that the administration would invoke both the Packwood-Magnuson amendment, which would cut Japan's fishing quota in U.S. waters by 50 percent the first year and 100 percent the next, and the Pelly amendment, which would embargo all fish imports from Japan.

Tokyo shot back that the U.S. threats were discriminatory since Iceland's research whaling program has not been threatened with retaliation. That does seem to be the case: Iceland proposed reducing its program in exchange for continued U.S. fishing rights. Tokyo had also scaled back its program (from 875 mammals), but is still facing sanctions. If the IWC votes against Japan, Tokyo has warned that it would consider withdrawing. The sanctions may be symbolic in any case since the administration has not yet granted Japan a fishing quota for this year. (Japan was allowed to take 104,000 metric tons in 1987.) Moreover, U.S. exports of fish products to Japan are twice the value of this country's imports from Japan.

JEI Personnel Changes

The Japan Economic Institute is pleased to announce the appointment of Barbara Wanner as senior political analyst and editor of the Japan Economic Survey. She replaces Michael W. Chinworth, who has accepted a position as project director and program associate with Massachusetts Institute of Technology's Japan Program on Science and Technology.

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J A P A N · E C O N O M I C · I N S T I T U T E

JEI

R E P O R T

A Two-Part Report: A and B

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OFFSHORE PRODUCTION: BOON OR BANE FOR THE JAPANESE ECONOMY?

Summary

What effect does expanded foreign direct investment in manufacturing have on employment opportunities at home and on the investing country's trade balance? That question produced a heated but ultimately inconclusive debate in the United States in the 1970s. Now economic policymakers and corporate planners in Japan are grappling with the same issue. The recent proliferation of overseas production facilities has stirred fears that Japanese manufacturers will soon be exporting jobs in volume instead of cars, steel and consumer electronics products. These worries are premature, in part because Japan's foreign manufacturing presence is too limited to have a near-term impact on domestic output. But a reduction in manufacturing employment over the long run is probably inevitable, although the cutback by the end of the 1990s might not be as deep as the 600,000 to 800,000 job loss government agencies initially predicted. At the same time, stepped-up offshore production is unlikely to narrow the gap between exports and imports by the big margin Tokyo has projected.

Japanese Foreign Direct Investment Takes Off

Two decades after surging U.S. investment in foreign production facilities made the phrase multinational corporation part of the business vocabulary, Japanese manufacturers are finally starting to supply a measurable share of the world market from overseas plants. Japan's big trading companies internationalized their operations in the 1960s, setting up offices around the globe to facilitate the distribution of Japanese-made products and handle the shipment of agricultural and industrial inputs back to Japan. Japanese exporters opened

sales subsidiaries in the United States and other promising markets during this period, but few companies took the next step of investing in offshore factories. The reason was simple: there was little incentive to produce abroad. Wage rates were relatively low, the yen was undervalued and exports, while increasing, had not generated a backlash overseas. Moreover, the government controlled the outflow of capital until 1969, and the business community lacked the managerial resources to support foreign investment.

This calculus changed in the 1970s. The international competitive advantage Japanese exporters had gained from low labor costs began to erode as tightening labor markets accelerated wage increases and the 1971 revaluation of the yen magnified these increases in dollar terms. The two oil shocks and the run-up of other commodity prices during the decade also jacked up production costs in Japan by bigger margins than in many competitor nations. Already pinched, the steep appreciation of the yen in 1978 delivered another blow to exporters. At the same time, trade barriers began to spring up in key Japanese export markets, particularly the United States, and a number of developing countries adopted policies to replace imports with locally made products.

Despite the push and pull of these factors, overseas investment did not increase much beyond a trickle during the 1970s. In most industries this response to the hike in wages and material and energy prices ranked a distant third to cost-cutting at home and shifting domestic output to products with higher value-added. Textiles were a major exception, with producers moving some production to neighboring Asian countries or Latin America, but few other suppliers of labor-intensive products followed them. Electric machinery manufacturers also numbered among the mavericks by transferring labor-intensive production processes to developing countries, although this move was generally limited to final assembly of low-end products. In addition, a small cross section of companies in the metals, chemicals and wood and paper products industries made investments in Latin America, Asia and North America to tap lower-cost raw material and/or energy supplies. Most of the remaining names on the short list of foreign investors during the 1970s were companies that set up operations in the United States to get behind actual or potential trade barriers.

The trickle of foreign investment finally turned into a steady stream at the start of the 1980s. By then exporters had accepted the fact that they could no longer afford to consider offshore production a last-ditch response to the new conditions of international competition. Limits to the returns from cost-cutting and product upgrading over the short to medium run required a change in strategy; so did the spreading backlash in the United States, Europe and elsewhere to the seemingly nonstop growth of made-in-Japan shipments. But for most exporters, production abroad remained a second-best solution until the yen began to soar in value in the fall of 1985. At that point top management generally acknowledged that their options had been reduced to two -- where to invest overseas and when.

This change is clearly marked in Japan's foreign investment data. The amount of money going into overseas production facilities was running between

\$2.1 billion and \$2.6 billion a year during the FY 1981-FY 1985 period. In the fiscal year starting in April 1986, though, the figure swelled to \$3.8 billion (see Table 1). But even with this jump and a much bigger gain -- perhaps twice as large -- in the current fiscal year, Japanese manufacturers still have a long way to go before their offshore operations begin to rival those of American companies.

Table 1: Japan's Foreign Direct Investment in Manufacturing*

(in millions of dollars)

	<u>Cumulative Total Investment</u>	<u>Cumulative Manufacturing Investment</u>	<u>Manufacturing Addition</u>		
			<u>Total</u>	<u>North America</u>	<u>Asia</u>
FY 1986	\$105,970	\$28,206	\$3,806	\$2,198	\$804
FY 1985	83,649	24,400	2,352	1,224	460
FY 1984	71,431	22,048	2,505	1,242	517
FY 1983	61,276	19,542	2,588	991	740
FY 1982	53,131	16,952	2,099	842	542
FY 1981	45,403	14,853	2,280	980	687
FY 1980	36,497	12,573	1,706	398	724
FY 1979	31,804	10,867	1,693]		
FY 1978	26,809	9,174	2,035]	773	1,295
FY 1977	22,211	7,139	1,052	202	331
FY 1976	19,405	6,087	921	223	183
FY 1975	15,943	5,166	1,027	140	470
FY 1974	12,666	4,139	898	n.a.	n.a.
FY 1973	10,270	3,241	1,496	n.a.	n.a.
FY 1972	6,773	1,745	525	n.a.	n.a.
FY 1966-FY 1971	4,436	883	---	---	---
FY 1951-FY 1965	950	337	---	---	---

*Figures cover investments reported to and approved by the Ministry of Finance.

Source: Ministry of Finance

For starters, Department of Commerce data indicate that U.S. multinationals had invested \$107.2 billion in overseas manufacturing facilities by yearend 1986, while the Ministry of Finance places the March 31, 1987 value of Japanese foreign investment in manufacturing at \$28.2 billion. But this amount as well as the \$106 billion total figure for Japan are thought to overstate the size of its international investment presence since they are based on investment plans reported to the ministry, not actual flows. A more realistic set of numbers, derived from the balance of payments data, is \$72 billion overall at the end of 1986 and \$19 billion or so in manufacturing -- which is roughly what American manufacturers had spent on foreign factories as of the mid-1960s.

A comparison of offshore-to-domestic production or sales ratios underscores the fact that Japanese companies have a lot of catching up to do before

they can be considered true multinational producers. Sales by U.S. foreign manufacturing affiliates have equaled 20 percent-plus of domestic sales since the start of the 1980s, including 23.8 percent in 1985. The comparable figure for Japan is a fraction of this number -- something on the order of 5 percent. Survey data collected by the Ministry of International Trade and Industry for FY 1985 put the ratio at only 3 percent (see Table 2), down from 4.3 percent in FY 1984 and 3.9 percent in the April 1983-March 1984 period. But this drop was largely a statistical quirk, the result of translating sales reported by overseas production subsidiaries in dollars and other foreign currencies back to yen at Y178.60=\$1.00, March 1986's closing rate, in place of Y250.65, the year-earlier figure. Using the March 1985 conversion rate lifts the ratio to 4.2 percent.

Employment figures also highlight the differences between Japan's foreign production subsidiaries and U.S. affiliates. Nearly 4.4 million people were employed by the overseas manufacturing units of American companies at the end of 1985. Just over two-thirds of these jobs were in other industrial countries, including 2.1 million in Europe, although 80 percent-plus of all U.S. foreign manufacturing investment has gone into these markets, primarily for the production of capital-intensive products like chemicals, industrial and commercial machinery and motor vehicles.

In contrast, the foreign manufacturing affiliates of Japanese businesses had about 800,000 employees in March 1986. Three-fourths of this workforce was in the third world, particularly Asia, where 450,000 people alone were employed in such labor-intensive industries as electric machinery (159,000) and textiles (98,000). But this concentration reflects the early pattern of Japanese investment, not recent trends, which have nearly evened the split between manufacturing holdings in the United States and other industrial nations and those in developing countries (see Appendix Tables 1-3).

Job Drain?

Will Japanese manufacturers start exporting jobs now that offshore production has joined cost-cutting and diversification on the list of corporate strategies for dealing with the appreciating yen? Not necessarily, if recent history is any guide. The manufacturing sector generated an extra 730,000 jobs during the 1983-85 export boom period, raising total employment to a record 14.5 million-plus. Most of these gains, not surprisingly, were in the huge electronics, nonelectric machinery and transportation equipment businesses, centered on electronic components, computer equipment, applied electronics products, metalworking and other specialized industrial machinery, service industry machinery, and motor vehicles and parts (see Table 3 and Appendix Table 4). But with one or two exceptions, these same industries were at the forefront of the offshore production movement, expanding abroad more often than not because of protectionist pressures.

Conversely, it is hard to find any link between overseas operations and the loss of jobs in the textiles, chemicals, nonmetallic mineral products and metals industries during the 1983-85 period since foreign investment activity in these fields was also on the downswing. The same in fact holds for the elimination of 320,000 manufacturing positions over the course of 1986 and 1987 -- the take-off years for corporate investment abroad, although at this level of aggregation it is admittedly impossible to separate the employment effects

Table 2: Indicators of the Performance of Foreign Affiliates of Japanese Companies, FY 1985*

(in billions of yen unless otherwise indicated**)

	Number of Affiliates	Total Capital	Total Sales	Ratio of Foreign to Domestic Sales	Production	Employment	Net Profits	Profit Margin
Manufacturing	2,242	Y2,429	Y9,949	3.0%	Y3,914	800,836	Y-35	-0.4%
Food Products	116	82	326	0.9	120	21,081	3	0.8
Textiles	172	157	620	2.7	397	121,690	16	2.6
Wood and Paper Products	48	122	183	1.2	131	11,788	6	3.4
Chemicals	318	334	613	2.0	207	38,999	14	2.2
Steel	116	217	896	5.3	256	73,575	-98	-10.9
Nonferrous Metals	60	118	246	2.7	141	22,990	6	2.5
Nonelectric Machinery	197	87	514	3.4	94	40,431	1	0.2
Electric Machinery	534	469	3,704	7.4	1,382	252,861	49	1.3
Transport Equipment	272	648	2,042	5.6	779	133,958	-51	-2.5
Precision Instruments	82	25	234	3.4	77	17,546	6	2.6
Petroleum Products	7	8	2	0.0	1	185	0	-5.9
Other	320	161	568	0.8	331	65,732	13	2.3
Agriculture, Forestry and Fisheries	82	27	397	--	--	15,928	-2	-0.4
Mining	105	462	970	--	--	60,115	40	4.2
Construction	190	64	859	--	--	26,403	4	0.5
Trade and Sales	1,984	1,030	38,151	--	--	125,248	168	0.4
Services	281	104	200	--	--	17,500	2	0.8
Other	459	456	427	--	--	11,038	6	1.5
Total	5,343	4,572	50,953	--	--	1,057,068	184	0.4

*These results are based on the responses of 1,413 of the 3,385 Japanese corporate investors to which questionnaires were sent. Given the low response rate, the findings must be interpreted with care. Moreover, the appreciation of the yen deflates the figures for sales, production and profits since these numbers were originally stated in dollars or other foreign currencies.

**The yen figures were derived using an exchange rate of Y178.60=\$1.00, the March 31, 1986 closing rate.

Source: Ministry of International Trade and Industry, January 1988

of expanded offshore production from those caused by reduced export shipments, increased import competition and/or shifts in demand at home. Survey evidence, however, supports the argument that there was little or no correlation. For example, more than four-fifths of the 190 manufacturers responding to a July 1987 Long-Term Credit Bank of Japan survey said that their foreign plants had had no impact on the domestic employment situation -- the same proportion indicating that overseas investment has been independent of capital spending in Japan.

But is past experience really a reliable indicator of what might happen to manufacturing employment in Japan given the big gains projected for foreign investment? Government agencies are certainly not optimistic. Assuming that the outflow of funds would continue to expand at the FY 1980-FY 1986 average annual rate of 14 percent through the end of the 1990s, a MITI advisory group recently estimated that increased overseas production would cost Japan 600,000 manufacturing jobs by 1995 and perhaps as many as 800,000 by the year 2000. A 1986 Economic Planning Agency study placed the potential job loss by the end of this century at 600,000, while the 1987 labor white paper predicted the elimination of 450,000 manufacturing positions over the next 10 years.

Even with the continued growth of employment opportunities in the non-manufacturing sector, these numbers could spell trouble for the Japanese economy. But there are at least three factors that will minimize the fallout from offshore manufacturing operations over the medium run and might contain the long-term job loss. The primary one is the type of work performed by foreign affiliates in the electronics, nonelectric machinery and automotive industries, which now account for two-fifths of Japan's foreign investment. Whether in the United States or elsewhere, these subsidiaries do final assembly, putting together components or subassemblies mainly imported from Japan.

This sourcing arrangement is unlikely to change significantly over the near term despite the increasing cost of using Japanese-made imports. Most Japanese affiliates are simply too new to have gone through the time-consuming process of identifying and qualifying host-country suppliers for more than a fraction of their parts requirements. At the same time, local management is generally unwilling to consider the alternative -- in-house production of components -- until the company has gained experience in the assembly field.

The small but rising number of Japanese manufacturers opting to expand their offshore production operations through takeovers will also protect jobs in Japan since acquisitions are normally a means of diversifying into new product areas or, less frequently, adding capacity in existing product lines, not a way of replacing output at home. But there are costs associated with this expansion strategy because the money used for foreign acquisitions could have been invested in Japan. The same trade-off applies to a significant number of greenfield foreign investments. In these cases, a manufacturer opts to build a factory offshore rather than in Japan to meet increased demand for a product; existing Japanese jobs are not jeopardized, but employment opportunities are lost.

Help for the Trade Balance?

Although worried that the jump in foreign manufacturing investment will drain a large number of jobs from Japan, government policymakers find a silver

Table 3A: Distribution of Employment in the
Manufacturing Sector

	1977	1981	1985
Food Products	10.5%	9.3%	9.3%
Tobacco Products, Beverages and Feed	*	1.3	1.3
Textile Mill Products	7.4	6.5	5.6
Apparel and Made-up Textile Products	4.8	4.9	5.0
Lumber and Wood Products	3.8	3.2	2.5
Furniture and Fixtures	2.5	2.4	2.0
Pulp, Paper and Paper Products	2.8	2.7	2.5
Printing and Publishing	4.4	4.7	4.7
Chemicals and Related Products	4.2	3.9	3.6
Petroleum Refining	0.4	0.4	0.3
Plastic Products	**	3.1	3.5
Rubber Products	1.5	1.5	1.5
Leather and Leather Products	0.8	0.8	0.7
Nonmetallic Mineral Products	4.9	4.8	4.3
Steel	4.5	4.0	3.6
Nonferrous Metals	1.9	1.8	1.5
Fabricated Metal Products	7.1	7.2	7.2
Nonelectric Machinery	9.8	10.0	10.3
Electric Machinery	11.9	13.9	16.8
Transportation Equipment	8.9	8.7	8.8
Precision Instruments	2.4	2.6	2.4
Other	5.4	2.5	2.4
Total	100.0	100.0	100.0
Total Employment (in thousands)	10,246	10,568	10,890

*Included in food products.

**Included in other.

Source: Ministry of International Trade and Industry

Table 3B: Distribution of Shipments in the
Manufacturing Sector

	1977	1981	1985
Food Products	11.8%	7.9%	7.7%
Tobacco Products, Beverages and Feed	*	2.8	3.2
Textile Mill Products	4.5	3.6	3.0
Apparel and Made-up Textile Products	1.6	1.4	1.4
Lumber and Wood Products	2.6	2.0	1.5
Furniture and Fixtures	1.4	1.3	1.1
Pulp, Paper and Paper Products	3.2	3.0	2.8
Printing and Publishing	3.1	3.3	3.4
Chemicals and Related Products	8.1	8.0	7.7
Petroleum Refining	5.8	7.1	4.9
Plastic Products	**	2.6	3.0
Rubber Products	1.1	1.1	1.1
Leather and Leather Products	0.5	0.5	0.4
Nonmetallic Mineral Products	3.7	3.8	3.3
Steel	8.6	7.7	6.7
Nonferrous Metals	3.4	3.2	2.4
Fabricated Metal Products	4.9	4.9	4.9
Nonelectric Machinery	8.1	8.6	9.1
Electric Machinery	9.7	11.4	15.4
Transportation Equipment	12.3	12.5	13.6
Precision Instruments	1.5	1.7	1.7
Other	4.1	1.5	1.5
Total	100.0	100.0	100.0
Total Shipments (in billions)	Y154,943	Y224,712	Y265,321

*Included in food products.

**Included in other.

Source: Ministry of International Trade and Industry

lining in the growth of offshore production -- a reduction in Japan's huge trade surplus as exports are replaced by products made abroad and imports are bolstered by purchases from overseas plants. In fact, the Industrial Structure Council, which advises MITI, has projected that expanded foreign production will cut the record 1986 trade surplus of \$82.7 billion by \$18.9 billion in 1990 and by \$46.8 billion in 1995.

The trade surplus is sure to come down; attributing such an enormous change to overseas output is another matter. On the export side, shipments of finished products will decline, but this drop will be offset at least in part and perhaps largely by an expanded outflow of components and subassemblies to foreign assembly subsidiaries. In addition, the proliferation of offshore plants will undoubtedly boost the demand for made-in-Japan production equipment. On the other side of the ledger, the long and increasing list of Japanese manufacturers that have announced plans to bring in products from their affiliates may have caused the ISC to overestimate the future growth of imports. The plans are there, but the volumes envisioned are too small individually and collectively to lift imports by a large percentage.

Economic policy planners have also overlooked the possibility that some of the drop in the trade surplus will be countered by an increase in direct investment income, keeping the current account surplus at a politically dangerous level. This oversight is understandable. As relative newcomers, most overseas production subsidiaries have barely turned the corner on profitability or are still operating in the red. Even when this situation changes, the affiliates can be expected to reinvest nearly all their earnings based on what Japanese companies operating in the United States have done. But at some point down the road, profits should exceed investment requirements by a big enough margin to flow back to Japan.

For further information, contact Susan MacKnight.

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The views expressed in this report are those of the author and do not necessarily reflect those of the Japan Economic Institute.

APPENDIX

Table 1: Japan's Foreign Direct Investment by Country, FY 1982-FY 1986

(in millions of dollars)

	<u>FY 1982</u>	<u>FY 1983</u>	<u>FY 1984</u>	<u>FY 1985</u>	<u>FY 1986</u>	<u>Cumulative March 31, 1987</u>
United States	\$2,738	\$2,565	\$3,360	\$5,395	\$10,165	\$35,455
Canada	167	136	184	100	276	1,951
North America	2,905	2,701	3,544	5,495	10,441	37,406
Panama	722	1,223	1,671	1,533	2,401	8,841
Brazil	322	410	318	314	270	4,857
Mexico	143	121	56	101	226	1,556
Caymans	6	1	1	132	930	1,279
Bahamas	---	1	97	298	792	1,247
Peru	185	---	6	10	---	696
Bermuda	5	14	29	148	16	617
Latin America	1,503	1,878	2,290	2,616	4,737	20,373
Indonesia	410	374	374	408	250	8,673
Hong Kong	400	563	412	131	502	3,433
Singapore	180	322	225	339	302	2,571
Korea	103	129	107	134	436	2,118
Malaysia	83	140	142	79	158	1,283
Taiwan	55	103	65	114	291	1,051
Philippines	34	65	46	61	21	913
Thailand	94	72	119	48	124	884
China	---	---	114	100	226	513
Asia	1,384	1,847	1,628	1,435	2,327	21,790
Kuwait	41	66	55	34	41	1,309
Iran	0	1	0	0	---	1,003
Middle East	124	175	273	45	44	3,016
United Kingdom	176	153	318	375	984	4,125
Netherlands	73	113	452	613	651	2,337
Luxembourg	127	265	315	300	1,092	2,308
West Germany	194	117	245	172	210	1,552
France	102	93	117	67	152	970
Belgium	64	126	71	84	50	793
Switzerland	79	37	229	60	91	753
Spain	19	52	140	91	86	601
Europe	876	990	1,937	1,930	3,469	14,471
Liberia	434	323	281	159	289	2,744
Africa	489	364	326	172	309	3,678
Australia	370	166	105	468	881	4,502
Oceania	421	191	157	525	992	5,234
Total	7,703	8,145	10,155	12,217	22,320	105,970

Source: Ministry of Finance

Table 2: Japan's Foreign Direct Investment by Sector, FY 1982-FY 1986

(in millions of dollars)

	<u>FY</u> <u>1982</u>	<u>FY</u> <u>1983</u>	<u>FY</u> <u>1984</u>	<u>FY</u> <u>1985</u>	<u>FY</u> <u>1986</u>	<u>Cumulative</u> <u>March 31,</u> <u>1987</u>
Manufacturing Sector	\$2,076	\$2,588	\$2,505	\$2,352	\$3,806	\$28,206
Food Products	78	77	118	90	127	1,218
Textiles	67	174	85	28	63	2,146
Wood and Paper Products	76	91	115	15	57	1,178
Chemicals	322	450	223	133	355	4,337
Metals	468	479	718	385	328	5,518
Nonelectric Machinery	164	169	185	352	626	2,597
Electric Machinery	267	502	409	513	987	4,734
Transport Equipment	439	486	437	627	828	4,201
Other	195	160	215	208	435	2,276
Nonmanufacturing Sector	5,478	5,357	7,429	9,536	17,949	74,285
Agriculture/Forestry	40	18	26	12	15	795
Fisheries	22	17	24	42	52	494
Mining	685	382	484	598	669	12,424
Construction	44	55	112	94	250	1,047
Trade/Sales	1,899	1,164	1,482	1,550	1,861	14,538
Banking/Finance/Insurance	533	1,167	2,085	3,805	7,240	18,099
Services	702	622	681	665	1,560	6,246
Transportation	924	1,363	1,651	1,240	1,925	7,826
Real Estate	354	375	430	1,207	3,997	6,531
Other	276	193	454	322	379	6,285
Branch Offices	149	200	221	329	566	2,884
Real Estate Transactions*	---	---	---	---	---	595
Total	7,703	8,145	10,155	12,217	22,320	105,970

*Overseas real estate transactions have been excluded from Japan's foreign direct investment data since December 1, 1980 because of changes in the Foreign Exchange and Foreign Trade Control Law.

Source: Ministry of Finance

Table 3: Japan's Foreign Direct Investment by Industry and Region, March 31, 1987

(in millions of dollars)

	North America	Latin America	Asia	Middle East	Europe	Africa	Oceania	Total
Manufacturing Sector	\$9,905	\$4,833	\$8,321	\$1,260	\$2,458	\$223	\$1,206	\$28,206
Food Products	574	199	284	0	93	8	60	1,218
Textiles	265	419	1,203	4	210	39	6	2,146
Wood and Paper Products	651	197	200	-	2	0	128	1,178
Chemicals	963	559	1,339	1,124	227	19	105	4,337
Metals	1,261	1,687	1,758	59	263	127	364	5,518
Nonelectric Machinery	1,235	356	675	11	278	1	41	2,597
Electric Machinery	2,732	324	1,095	13	526	7	38	4,734
Transport Equipment	1,506	982	822	4	498	15	374	4,201
Other	718	110	946	45	363	7	88	2,276
Nonmanufacturing Sector	26,378	15,474	13,144	440	11,387	3,452	4,011	74,285
Agriculture and Forestry	250	179	247	2	1	7	109	795
Fisheries	136	103	108	1	2	90	53	494
Mining	1,258	1,525	6,438	191	890	579	1,544	12,424
Construction	457	200	238	40	56	21	36	1,047
Trade and Sales	8,467	1,232	1,270	19	2,874	7	669	14,538
Banking, Finance and Insurance	6,251	4,275	1,069	93	5,977	3	432	18,099
Services	1,592	681	2,489	4	348	639	494	6,246
Transportation	97	6,058	253	2	40	1,308	66	7,826
Real Estate	5,755	19	404	-	144	-	209	6,531
Other	2,115	1,203	627	87	1,056	798	399	6,285
Branch Offices	638	43	289	1,315	588	1	10	2,884
Real Estate Transactions*	485	23	37	2	38	2	7	595
Total	37,406	20,373	21,790	3,016	14,471	3,678	5,234	105,970

*Overseas real estate transactions have been excluded from Japan's foreign direct investment data since December 1, 1980.

Source: Ministry of Finance

Table 4: Employment, Shipments and Value Added in the Manufacturing Sector, 1977, 1981 and 1985*

	Employment			Shipments			Value Added/Shipments		
	1977	1981	1985	1977	1981	1985	1977	1981	1985
Food Products	1,077,608	979,645	1,016,731	Y18,319,688	Y17,772,877	Y20,541,874	28.6%	30.3%	31.8%
Tobacco Products, Beverages and Feed	**	133,845	139,767	**	6,359,048	8,608,325	**	23.6	22.9
Textile Mill Products	761,288	681,655	609,462	6,913,646	8,018,910	8,086,962	34.1	36.0	37.2
Apparel and Made-up Textile Products	494,275	521,133	539,538	2,481,685	3,196,350	3,651,160	42.9	45.3	46.6
Lumber and Wood Products	390,528	333,375	276,444	4,101,059	4,485,082	4,024,996	30.6	30.9	34.2
Furniture and Fixtures	257,564	251,612	221,663	2,145,425	2,812,141	2,842,103	41.1	41.5	42.4
Pulp, Paper and Paper Products	291,358	284,322	275,495	5,013,151	6,826,748	7,388,886	30.3	28.1	31.0
Printing and Publishing	445,785	493,362	515,213	4,844,246	7,337,615	8,917,793	53.0	53.6	51.0
Chemicals and Related Products	428,105	408,072	395,748	12,522,851	18,072,411	20,552,413	35.6	33.9	38.7
Petroleum Refining	44,665	44,373	37,697	8,938,443	15,994,016	12,947,907	8.5	8.6	8.3
Plastic Products	***	327,785	382,247	***	5,883,324	8,052,212	***	33.6	35.9
Rubber Products	151,995	155,835	165,315	1,728,188	2,575,782	3,007,703	40.6	38.1	39.7
Leather and Leather Products	77,390	83,235	76,509	780,474	1,017,667	1,030,582	34.8	35.3	37.1
Nonmetallic Mineral Products	507,017	507,081	465,483	5,717,079	8,633,055	8,772,333	44.9	42.6	48.9
Steel	464,306	422,140	388,357	13,247,979	17,227,731	17,754,272	23.2	27.8	29.7
Nonferrous Metals	196,204	189,890	163,392	5,253,916	7,299,488	6,383,626	23.4	24.4	24.5
Fabricated Metal Products	731,750	763,480	786,604	7,636,591	10,947,848	13,094,388	42.6	41.8	42.2
Nonelectric Machinery	1,003,617	1,058,385	1,126,614	12,562,741	19,429,253	24,225,201	41.9	41.2	41.3
Engines and Turbines	55,748	60,355	56,196	919,412	1,624,610	1,896,106	34.9	42.3	41.4
Agricultural Machinery	55,085	43,850	40,623	913,724	757,756	831,438	39.0	38.0	43.1
Construction and Mining Machinery	71,593	72,443	70,002	1,292,137	2,063,935	2,156,750	39.7	35.8	31.7
Metalworking Machinery	140,815	163,999	194,840	1,417,869	2,745,224	3,699,979	47.8	45.5	47.2
Textile Machinery	37,804	35,623	30,613	328,219	492,440	498,998	47.5	47.4	44.8
Specialized Industrial Machinery	83,866	92,442	103,849	912,620	1,392,860	2,188,940	47.5	46.5	41.6
General Industrial Machinery	252,649	253,439	236,914	3,295,044	4,953,614	5,038,328	42.7	40.7	40.5
Office Machines, Sewing and Knitting Machinery, Refrigeration and Service Industry Machinery	128,777	140,364	156,526	1,766,302	2,715,319	4,098,531	32.6	30.7	34.3
Other	177,280	195,870	237,051	1,717,415	2,683,496	3,816,130	48.2	48.9	48.8
Electric Machinery	1,221,199	1,468,796	1,825,314	15,021,104	25,693,042	40,842,176	38.8	37.5	36.4
Electric Transmission and Distribution Equipment	295,269	336,820	375,854	3,151,712	4,989,281	6,538,484	39.8	38.1	38.1
Appliances	108,740	113,217	138,224	1,866,721	2,464,133	3,948,270	37.7	36.5	37.8
Electric Lighting and Wiring Equipment	45,979	42,032	45,365	540,914	666,475	835,524	35.6	34.8	36.9
Communications Equipment, Consumer Electronics	328,701	360,198	330,990	4,796,444	7,182,613	7,861,898	32.8	33.5	32.9
Computers and Peripheral Equipment	68,090	143,477	143,477	4,796,444	7,182,613	7,861,898	32.8	33.5	32.9
Medical Equipment, Video Equipment, Other	94,535	83,970	158,863	1,373,017	1,729,027	4,689,370	49.0	47.5	37.1
Applied Electronics Products	41,557	40,428	48,198	392,025	554,041	943,492	51.3	49.2	45.0
Electric Measuring Equipment	265,246	374,099	524,384	2,445,444	5,059,033	9,757,995	42.2	40.3	37.3
Semiconductors, Other Electronic Components	41,172	49,942	59,959	454,828	852,121	1,114,627	43.0	42.2	41.0
Other	908,456	917,863	961,590	19,034,300	28,051,085	36,179,341	30.0	26.7	27.0
Transportation Equipment	621,061	700,078	764,501	14,428,578	23,798,558	31,479,293	27.5	25.5	25.6
Motor Vehicles and Parts	17,978	19,471	15,775	217,207	312,991	294,795	42.4	41.9	40.0
Railroad Equipment	20,958	20,072	18,721	281,861	383,128	352,220	36.7	40.2	40.4
Bicycles and Parts	207,940	139,245	118,019	3,566,899	2,878,970	2,868,476	37.4	37.7	34.1
Ship Building and Repair	24,588	22,339	24,777	291,258	323,596	689,086	45.9	51.2	41.9
Aircraft and Parts	15,931	16,658	19,797	248,496	353,842	495,472	30.4	32.6	36.7
Other	242,784	279,039	261,784	2,364,279	3,802,347	4,381,262	42.9	39.1	41.9
Precision Instruments	550,158	262,678	258,982	6,315,913	3,276,125	4,035,036	37.3	41.1	41.7
Other	10,246,052	10,567,601	10,889,949	154,942,755	224,711,947	265,320,551	33.2	32.6	34.1
Total									

*Covers establishments with four or more workers. Employment figures are as of December 31 of the relevant year. Shipments are in millions of yen.
Value added = value of production - depreciation - value of industrial inputs - depreciation - value of excise and commodity taxes included in value of shipments.
**Included in food products.
***Included in other.

Source: Ministry of International Trade and Industry, Census of Manufactures: Report by Industries.

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J E I

R E P O R T

A Two-Part Report: A and B

NO. 5B
February 5, 1988

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Japan's Economy In 1987

If economic officials in Tokyo had known at the beginning of 1987 what was coming, they might have been very concerned. How could the economy, still reeling from the appreciation of the yen in 1986, survive a further 30 percent increase in 1987? Add the stock market crashes around the world in late October, and they would have had real reason to worry.

So it must have come as a surprise that the economy not only survived these unanticipated problems but even exceeded the forecasts issued before they occurred. More than one analyst has compared the economy's resilience in the face of these external disturbances to its behavior during the two oil shocks. This time, while the soaring yen did pull the economy down, increasing domestic demand turned out to be more important. The final figures are not in but inflation-adjusted growth is almost certain to exceed the government's original 3.5 percent forecast for fiscal year 1987, ending March 31. It is now forecasting 3.7 percent real growth for FY 1987.

The statistics for calendar 1987 now being released paint a remarkably clear picture of healthy growth led by increasing domestic demand. Mining and manufacturing production, for example, after getting off to a weak start, was strong throughout the second half of the year (see Table 1). Increases in production seem to be chasing increases in demand as inventories have declined on a year-to-year basis every month since May 1986. While initially the changes may have reflected caution about the economy's prospects, toward the end of 1987 inventory depletion accelerated as the economy's expansion appeared to pick up speed.

Table 1: Mining and Manufacturing Index
(percentage change from year-earlier period)

	<u>Production</u>	<u>Inventories</u>
1983	3.6%	-5.1%
1984	11.1	2.9
1985	4.6	8.6
1986	-0.4	-0.1
1987 (preliminary)	4.0	n.a.
1987		
January	0.5	-2.1
February	-0.1	-3.6
March	1.6	-4.7
April	0.3	-2.9
May	-0.8	-4.6
June	3.0	-5.0
July	4.1	-6.4
August	5.0	-5.7
September	5.3	-5.8
October	9.0	-4.9
November	10.5	-4.7
December (preliminary)	8.6	-5.2

Source: Ministry of International Trade and Industry

One might expect that the healthy growth in output would create pressure somewhere in the economy, but so far that has not happened. While the Bank of Japan continues to worry about inflation, central bankers in other countries may envy its situation. In 1987, prices showed remarkable stability, with wholesale prices falling 3.7 percent, their fifth straight yearly drop. Consumer prices rose 0.1 percent, the lowest rate of increase in 29 years. The Management and Coordination Agency attributed the performance to the yen's appreciation and lower crude oil prices. For example, food prices, which are heavily dependent on import prices, declined 0.9 percent.

The job situation also generally improved during the year, although the average unemployment rate equaled 1986's postwar high of 2.8 percent. After hitting a peak of 3.3 percent in May, the jobless rate generally declined for

the rest of the year, standing at a seasonally adjusted 2.6 percent in December. Many analysts caution against comparing unemployment rates in Japan with those in other countries because the measurement techniques and macroeconomic interpretations are different.

The pattern of change in the labor market in Japan is confirmed by other data: the ratio of job offers to job seekers has shown a steady improvement since November 1986 on a seasonally adjusted basis. For 1987 it stood at 0.70, an improvement from 0.62 the previous year, and is now at the highest level in 13 years. Hours of overtime in manufacturing, a closely watched indicator of labor demand, ended 21 consecutive months of year-to-year declines in May and have since increased for six straight months. The figure is now higher than it was before the decline began in mid-1985.

Increasing private and public demand was clearly a major reason for the year's growth. Spurred by lower interest rates, housing was particularly strong, with 1.7 million starts, a jump of 22.7 percent. There were some indications at yearend that growth was slowing, although the December figure was still comfortably ahead of the year-earlier number. Government spending also increased sharply during the year.

Trade did not contribute to the economy's strong performance, although the numbers may suggest otherwise. As Table 2 shows, the trade (both exports and imports valued f.o.b.) and current account surpluses in dollar terms showed a slight increase, suggesting that foreign criticism of Japan's trade imbalance is unlikely to diminish. Expressed in yen, the two surpluses showed a sharp decline during 1987, meaning changes in foreign trade by itself would have led to negative growth during the year. The difference, of course, is attributable to the appreciating yen: exports, which were down in yen terms, soared enough in dollar terms to overwhelm the increase in imports, which were up sharply in both dollar and yen terms.

Table 2: Balance of Payments

	<u>Millions of dollars</u>	<u>Billions of yen</u>
<u>Trade</u>		
1986	\$92,827	¥15,341
1987	96,464	13,914
<u>Current Account</u>		
1986	85,845	14,179
1987	86,688	12,496
<u>Long-term Capital</u>		
1986	-131,461	-21,741
1987	-137,127	-19,892

Source: Bank of Japan

While in the last half of the year all measures of trade and the current account generally showed a declining surplus, there was a year-to-year increase in the dollar-denominated current account surplus for December. This rise renewed fears that the surpluses might prove intractable.

Douglas Ostrom

Yen Settles Down

Suddenly all is quiet in the currency markets. After wild gyrations in November and December, both the yen and dollar were remarkably stable during January. In the last week of the month, for example, the range between the dollar's high and low value on the Tokyo foreign exchange market was only half a yen. The dollar closed at 127.18 yen and averaged 127.66 yen, down from 128.35 yen in December. The markets more or less shrugged off both favorable U.S. trade statistics and somewhat disappointing Japanese figures.

The new tranquility seems to suit the Bank of Japan. In a Tokyo speech the governor of the bank, Satoshi Sumita, argued for exchange rate stability as a policy objective, pointing out that exchange rate variations can affect prices, interest rates and the stock market. By contrast many in the Reagan administration believe that stabilizing exchange rates is impractical because picking the appropriate rate is difficult or impossible and, once chosen, will soon change. Such officials would argue that monetary and fiscal policies influence the exchange rate through market forces. In this view the exchange rate is an effect rather than a cause of changes elsewhere in the economy.

For the next few months at least, a major factor will be the attitudes of Japanese and other investors concerning the market for U.S. securities. Last year private Japanese investors were net buyers of \$73 billion worth of U.S. and other foreign bonds, while foreigners bought about \$7 billion net in Japanese bonds. While foreign purchasers profited as the yen appreciated, Japanese who invested overseas lost heavily.

The BOJ points to interest rates on comparable U.S. long-term securities that are 4.5 percentage points higher than Japan's as evidence that Japanese investors should be more than willing to invest here. Of course, should the dollar fall dramatically, that difference would be far too small to compensate for the exchange rate loss. On the other hand, a stable currency can be self-reinforcing: if the dollar is expected to stay where it is, dollar investments are attractive, which in turn keeps the dollar from falling.

Investors will be making their decisions at a time when interest rates may be heading lower in both countries. In late January a key Japanese rate, the long-term prime, was lowered by 0.2 percentage point to 5.5 percent. The money supply continues to grow rapidly, with the most widely followed measure, M2 + CDs, up by 11.5 percent in December on a year-to-year basis, putting downward pressure on short-term interest rates.

In the United States, rates fell during January and speculation continues that the Federal Reserve Board will expand the money supply and reduce interest rates further to head off an election year recession. While current

Japanese monetary policy makes this option safer than otherwise, the Fed still runs the risk that significantly looser money could quickly reduce the attractions of investing here and send the dollar down again.

Douglas Ostrom

Japan Burdened By Taxes

Debate over tax reform is heating up as the government prepares to submit spending and revenue plans for fiscal 1988. Prime Minister Noboru Takeshita and Finance Minister Kiichi Miyazawa are busily building a national consensus in favor of a new major indirect tax, while opposition parties are working to defeat this proposal. According to Ministry of Finance projections, the deficit will widen in FY 1989 unless spending is cut or revenue raised. The short-term outlook is rosy, however, as a resurgent economy is generating solid revenue growth.

As the Table shows, total fiscal 1988 revenues are expected to increase 5.3 percent to just over Y46.4 trillion (\$371.3 billion at Y125=\$1.00), thanks to a big jump in special account revenues (energy and excise taxes earmarked for local governments or the Fiscal Investment and Loan Program), and moderate growth in direct and indirect tax receipts. Of concern to MOF is the continued reliance on direct taxes. Personal, corporate and inheritance taxes will provide 72.2 percent of total revenues in fiscal 1988, up from FY 1987's 71.9 percent level. After reaching the 74 percent mark in FY 1974, the ratio fell to the 60 percent range until the 1980s, when it returned to and stayed above the 70 percent level. In contrast, indirect taxes will provide 27.8 percent of total revenues in FY 1988 compared with the previous year's 28.1 percent.

The fact that personal income tax receipts are expected to rise nearly 8 percent while corporate tax revenues expand less than 2 percent is also a warning signal to policymakers. Consumer spending probably will be dampened if income tax growth is greater than overall economic growth, putting pressure on plans to restructure the economy to rely on domestic demand. One component, the jump in inheritance tax revenues, can be laid to the sharp increase in land and stock prices, and is a one-time phenomenon, according to MOF officials. MOF also expects stock market activity to decline, as indicated by the 5.8 percent drop in expected transaction tax revenues.

In its annual report, MOF projects that the government will need to borrow an additional Y4.9 trillion (\$39.2 billion) in fiscal 1989 and Y5.5 trillion (\$44 billion) in fiscal 1990 if government subsidies to farmers and others are not slashed. MOF continues to embrace the view that the budget should be balanced by FY 1990, a position echoed by the prime minister. Officials have called for sharp cuts in farm and other subsidies, as well as in education and social security programs.

To avoid these cuts, the administration is urging comprehensive tax reform. Although no government official specifically mentioned a value-added tax in speaking to the Diet (see following article), the tax policy councils of the Finance Ministry and the Liberal Democratic Party are said to favor a 3 percent VAT. Former prime minister Yasuhiro Nakasone was forced to withdraw a 5 percent VAT proposal last year in the face of a withering public outcry, and the

opposition parties have condemned any new indirect tax and vowed to whip up public sentiment if the government introduces such legislation. Mr. Takeshita is trying to compromise, offering to cut income taxes in exchange for the introduction of a VAT. The idea is not likely to calm the opposition, and the prime minister will be hard put to advance his fiscal ideas during the current Diet session.

Jon Choy

Tax and Stamp Revenues, FY 1987-FY 1988

(in billions of yen and percentage change)

	FY 1987		FY 1988	
	<u>Initial</u>	<u>Revised</u>	<u>Initial</u>	<u>Change*</u>
<u>General Account Budget</u>				
Direct taxes	Y29,819	Y31,703	Y33,488	5.6%
Personal income tax	16,482	16,188	17,444	7.8
Withheld	12,878	12,303	13,266	7.8
Self-declared	3,604	3,885	4,178	7.5
Corporate income tax	11,824	13,722	13,931	1.5
Inheritance tax	1,513	1,793	2,113	17.8
Indirect taxes	11,375	11,384	11,602	1.9
Liquor tax	1,936	2,042	2,066	1.2
Tobacco tax	958	1,012	1,011	-0.1
Sugar tax	32	32	41	28.1
Gasoline tax	1,596	1,596	1,314	-17.7
Liquified petroleum gas tax	16	16	16	0.0
Aviation fuel tax	54	54	58	7.4
Petroleum tax	190	190	290	52.6
Commodity taxes	1,478	1,686	1,772	5.1
Playing card tax	1	1	1	0.0
Bourse tax	25	25	54	116.0
Securities transaction tax	1,179	1,766	1,663	-5.8
Travel tax	61	61	84	37.7
Admission tax	4	4	7	75.0
Vehicle tonnage tax	486	486	532	9.5
Customs duty	481	599	619	3.3
Tonnage tax	8	8	8	0.0
Stamp revenues	1,767	1,806	2,066	14.4
Sales tax**	1,103	--	--	n.a.
Total general account	41,194	43,087	45,090	4.6
<u>Special Accounts</u>				
Total	1,166.4	982.6	1,321.2	34.5
Total central government	42,360.4	44,069.6	46,411.2	5.3

*Initial FY 1988 compared to revised FY 1987.

**Proposed but never enacted.

Source: Ministry of Finance

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FINANCIAL LIBERALIZATION IN JAPAN: UPDATE AND IMPACT

Summary

Japanese financial institutions have become a significant force in global finance over the past several years thanks in large part to the cumulative impact of the Ministry of Finance's incremental approach to liberalization and reform of Japan's financial system. Now that the relatively easy changes have been made, however, the strategy faces two supreme tests: reforming the giant postal savings system and amending Article 65 of the Securities and Exchange Law that separates banking and securities operations.

While the Finance Ministry tackles these two issues, domestic and foreign companies will take full advantage of the past reforms to integrate Japan's financial network with the European and U.S. markets. This report reviews last year's changes, previews moves scheduled for this year and analyzes the impact of financial freedom on Japanese financial behavior.

A Brief Look Back

The process of eliminating the government's strongest financial controls and restrictions, which began in the late 1960s, culminated in the passage of a new foreign exchange control law in 1980. At that time external transactions were freed in principle, while key domestic markets remained firmly, if subtly, controlled (see JEI Report No. 10A, March 9, 1984). Companies did not take advantage of their new freedom, however, for fear of falling out of the Finance Ministry's favor if foreign activities were deemed undesirable. Since domestic

operations formed the vast bulk of day-to-day transactions, it is not surprising that Finance retained a great deal of influence.

The key to putting real impetus behind financial change was the May 1984 report of the Joint Japan-U.S. Ad Hoc Group on Yen/Dollar Exchange Rates, Financial and Capital Market Issues. The accord, worked out by then-Treasury Secretary Donald Regan and then-Finance Minister Noboru Takeshita, produced a series of immediate changes and promised a host of others (see JEI Report No. 22B, June 8, 1984) in three broad areas:

Yen internationalization - To increase the yen's role in international markets the real-demand rule and limits on currency swaps were eliminated, allowing speculative foreign exchange trading; regulations restraining the Euroyen market were eased; and a yen-denominated bankers' acceptance market (necessary if more trade was to be denominated in yen) was slated for opening in 1985.

Interest rate decontrol - The gradual decontrol of interest rates on deposits was intended to increase the role of free market mechanisms and to improve the returns to savers. By introducing new instruments, such as money market certificates and large time deposits, and lowering the minimums on existing instruments that paid market rates (certificates of deposit, for example), the Finance Ministry hoped to gradually bring Japanese markets more into line with those in New York and London.

Institutional restructuring - The strict compartmentalization of Japanese financial institutions that characterized the postwar system was scheduled for reform via a highly unusual route: greater access for foreign financial institutions. The first step was to allow foreign commercial banks to start trust banking operations, a move Japanese commercial banks were barred from making. Foreign institutions were also given greater opportunities to participate in domestic and Euroyen bond markets.

Between 1985 and 1987 the government gradually addressed other areas of concern to domestic and foreign interests while continuing to implement the 1984 report. The most significant developments are summarized below:

- The withholding tax on Euroyen instruments held by nonresidents was repealed January 30, 1985. Foreigners had complained that the tax made the instruments unattractive, hampering yen internationalization efforts.

- A short-term government bond market was opened April 1, 1985 to broaden the maturity structure of government debt and to provide another tool to monetary officials.

- Securities houses were allowed to trade certificates of deposit starting June 1, 1985, joining the 13 banks originally authorized in March.

- A government bond futures market was established October 15, 1985 to support the new market for short-term government bills.

- The first of six foreign securities firms admitted to the Tokyo Stock Exchange in late 1985 began trading in early 1986. Included among the six were three American companies: Merrill Lynch International Bank, Inc., Goldman Sachs International Corp. and Morgan Stanley International Ltd.

- Finance officials issued new capital ratio guidelines requiring a bank's net-worth-to-total-asset ratio to reach 4 percent by the end of fiscal 1986. In addition, accounting methods for loan guarantees and loans to subsidiaries were tightened. Both moves responded to fears that Japanese banks were undercapitalized compared to their foreign competitors.

- Small and medium-size securities companies were allowed to singly or jointly manage investment trusts in May 1986, and the ceiling set semiannually on new investment trusts was dropped in July. The changes allowed "spot trusts," which can be quickly opened and closed to take advantage of changing market conditions, to proliferate.

- Insurers were allowed to offer variable life insurance beginning in October 1986. The insured amount and the amount paid if the policy is canceled vary in line with the performance of the underlying investments. Since most insurance companies invest in stocks and bonds, variable insurance policyholders saw returns of 27 to 54 percent in 1986 compared with a 7 percent yield on standard insurance policies. Not surprisingly, the new policy has proved very popular.

- Regulations covering the booming investment advisory business were adopted November 26, 1986. As investment options proliferated, individual investors sought professional advice and were occasionally victims of fraud.

- The Tokyo International Banking Facility opened December 1, 1986 to lukewarm commercial interest. While the government hoped the new offshore banking facility would draw foreign capital like the New York and London facilities, taxes and regulations made it relatively unattractive.

The pattern of changes is instructive: initially liberalizing overseas activities in turn created pressure for domestic change. The bond market presents the clearest example. The Euroyen market was almost completely liberalized by mid-1986, while the home market suffered from various taxes and rigid flotation requirements and procedures. Not surprisingly, Euroyen bond activity was intense while domestic borrowing fell off sharply. Domestic regulations were eased in 1986 in an effort to revitalize the home market.

The Ministry of Finance continued to stretch the boundaries between commercial and investment banking by allowing foreign bank holding companies to open securities brokerages or advisory offices. Domestic banks and securities companies were also allowed to compete head-to-head in new markets, for example, certificates of deposit and bond futures. The two groups were also able to compete more strenuously for investor funds -- commercial banks by offering new savings instruments with market-determined rates, trust banks by offering accounts that granted them wide investment decision powers leading hopefully to higher returns, and securities houses through such tools as "sweep" accounts, which also promised higher returns in exchange for trading freedom.

1987 Recap

The Finance Ministry took the following actions in 1987:

- Trading of Japanese government bond futures was initiated on the London International Financial Futures Exchange on July 13 and on the Chicago Board of Trade in November, opening the way for round-the-clock trading of this instrument.

- Regulations limiting the amount of foreign holdings in trust and insurance company portfolios were liberalized as part of an effort to support the dollar and keep capital flowing to the United States.

- Interest rate decontrol advanced twice during the year. On April 1 the issue ceiling (amount outstanding compared to stockholders' equity) for certificates of deposit was raised to 300 percent from 250 percent; the issue ceiling for money market certificates was similarly increased. At the same time, maturities on money market certificates, which start at one month, were lengthened from one to two years. Moreover, the minimum size for MMCs was reduced to Y20 million (\$160,000 at Y125=\$1.00) from Y30 million (\$240,000), and the minimum unit for large time deposits paying market rates was lowered from Y300 million (\$2.4 million) to Y100 million (\$800,000). Then on October 5 the issue ceiling for both instruments was abolished; the minimum money market certificate was lowered to Y10 million (\$80,000); and the minimum term for a large deposit was reduced from three months to one month.

- The Ministry of Finance widened its unofficial policy allowing foreign banks to enter the securities market on June 3. European universal banks already operated brokerage offices, but American banks were now permitted to open joint venture securities firms with a nonfinancial company as long as their interest did not surpass 50 percent.

- On June 9 the Osaka Stock Exchange slipped around regulations barring stock futures by offering a futures contract based on a basket of 50 issues traded on the Tokyo Stock Exchange rather than the entire Nikkei 225 Average. The fact that the government allowed this encouraged the exchange to begin planning its own quasi-futures option.

- The minimum unit on the bankers' acceptance market was reduced from Y100 million (\$800,000) to Y50 million (\$400,000) on May 11, and the maximum settlement period was extended from six months to one year.

- Foreign participation in the primary government bond market was expanded by eliminating the requirement that foreign members of the bond-buying consortium open a special account with the Bank of Japan in order to bid directly at auctions (June). Additionally, the share of each placement allocated to foreign firms was raised from 1.19 percent to 5.7 percent (June), and an open auction system for 20-year bonds was instituted (November).

- Membership in the Tokyo Stock Exchange was broadened by 21 seats October 20, and the new members were announced December 16. Including one seat vacated due to a merger, six Japanese and 16 foreign firms won trading positions, including six American, four British, and two each from France, West

Germany and Switzerland. The new members will begin trading in mid-1988 when the exchange moves into new, larger facilities.

- A special panel to study the problem of insider trading was inaugurated October 19 in response to a bond futures trading scandal that rocked markets.

- A commercial paper market began operating November 20 with 178 companies eligible to float offers. With the minimum size set at Y100 million (\$800,000) and the interest rate pegged well below CDs, the market was expected to prove only moderately attractive. Nonetheless, at least 30 companies had issues out by the end of the year. At the same time, foreign companies were allowed to issue yen-denominated commercial paper in Europe in another bid to increase the international use of the yen.

Three other important events took place in 1987:

- The postal savings system established a fund management division on May 29 as the first step in its transformation from a simple depository to a provider of full banking services. In return for supporting the abolition of tax-exempt small savings accounts (which make up the majority of postal savings deposits) as outlined in MOF's tax reform plan, the Ministry of Posts and Telecommunications demanded the right to sell government bonds over the counter at its 19,000 post offices. The new division's initial assets amounted to Y2 trillion (\$16 billion), with additions of Y500 billion (\$4 billion) planned annually up to a total of Y15 trillion (\$120 billion). It is required for now to put half the funds into government bonds and the other half into foreign government bonds and blue-chip securities. Eventually, however, the division hopes to invest its portfolio as it sees fit. Japanese banks are very concerned about the postal savings system, especially since the postal authorities hope to offer loans and other investment instruments. With six times as many offices as the largest nationwide commercial bank, the postal savings system would be a formidable competitor.

- The Financial System Research Council submitted a report on the restructuring of the domestic banking industry December 4, calling for changes in four areas: foreign exchange transactions, sogo or mutual banks, long-term credit banking and trust banking (see JEI Report No. 46B, December 11, 1987). The basic thrust would be to eliminate the barriers between these fields, increasing merger and competitive possibilities. Only the first two changes are favored by all parties; sharp divisions emerge in debates on the latter two. Present long-term and trust banks want to preserve their privileges, while commercial banks seek an end to the barriers. The Finance Ministry will appoint several advisory committees in 1988 to study implementation measures.

- Tokyo joined in a landmark international agreement on bank capital adequacy ratios after more than a year of talks (see JEI Report No. 47B, December 18, 1987). The Bank for International Settlements announced December 10 that banks of the 10 industrialized nations will be held to the following guidelines by 1992: "core capital" (equity and retained earnings) must equal at least 4 percent of total risk-weighted assets and this ratio must reach 8 percent when secondary capital is included. Japanese banks will be allowed to include 45 percent of their unrealized stock gains in secondary capital, less than the 75 percent Tokyo had lobbied for but better than the total exclusion

sought by American and British officials. In any case, with current ratios between 2 percent and 3 percent, Japanese banks must raise a monumental amount of capital over the next four years.

The Impact

Not surprisingly, these changes have revolutionized both individual and corporate financial behavior. In classic textbook fashion, investors have demanded higher and higher returns as a wider range of options has become available. Zaitech, a term meaning financial technique, swept Japan as stock and bond markets rose to new highs. The October 1987 crash of equity markets around the globe, however, served as a reminder that greater yields mean greater risks. Although chastened somewhat, Japan remains bullish on its financial future.

- Individuals - Zaitech in this case meant diversifying into stocks, mutual fund-like instruments, deposits paying market rates and variable life insurance (see Table 1). According to the Bank of Japan's flow of funds data for the second quarter of 1987, individuals reduced their position in time and demand deposits (which pay fixed, very low rates) and traditional trust accounts in favor of more lucrative instruments. Certificates of deposit more than doubled from year-earlier levels of Y1.8 trillion (\$14.4 billion) to Y3.7 trillion (\$29.6 billion); securities investment trusts skyrocketed from Y1.8 trillion (\$14.4 billion) to Y4.2 trillion (\$33.6 billion); stock holdings leapt to Y347 billion (\$2.8 billion) from Y55 billion (\$440 million); and insurance investments rose from Y1.2 trillion (\$9.6 billion) to Y1.8 trillion (\$14.4 billion).

It is clear that Japanese savers have shown little hesitation about new instruments, and banks, securities companies and other financial institutions have provided a flood of new offerings. As far as equities are concerned, however, the stagnation of the Tokyo Stock Exchange in the aftermath of the global crash has dampened enthusiasm. (The failure of the price of Nippon Telegraph and Telephone Corp.'s shares to return to their historical highs has been particularly discouraging.) Thanks to better regulation of the investment advisory industry, the entry of foreign firms into the field, and government steps to guarantee certain instruments, individual investors remain eager customers.

- Nonfinancial corporations - Corporate finance managers have responded enthusiastically to the new environment. Thanks to record profits over the past several years, they have sought greater returns on their cash funds (see Table 2). Tokkin, or specified fund trusts, have been one of corporate zaitech's most important tools. The investor instructs the broker to trade only in a certain category of companies (biotechnology firms, for example). While strictly speaking the broker should ask the customer's permission to make a trade, in practice the broker has blanket permission to buy and sell. Corporate funds flowing into stocks jumped to Y403 billion (\$3.2 billion) in the second quarter of 1987 compared with Y74 billion (\$592 million) the previous year. Certificates of deposit also increased in popularity -- up to Y7.2 trillion (\$57.6 billion) compared to Y3 trillion (\$24 billion). Not everyone is convinced of zaitech's benefits, however. According to a February 1988 survey by the Japan Chamber of Commerce, 64 percent of the respondents had company policies prohibiting the active trading of stocks, bonds, real estate and gold.

Table 1: Japanese Personal Savings by Repository

(end of period in trillions of yen and percentage of total)

Fiscal Year	Savings and Deposits							Trusts	Insurance	Stocks	Total
	Total	Banks	Sogo Banks	Credit Unions	Postal Savings	Other					
1975 Share	Y106.5 68.9%	Y38.1 24.6%	Y9.1 5.9%	Y13.8 8.9%	Y24.6 15.9%	Y20.9 13.5%	Y8.9 5.8%	Y22.6 14.6%	Y16.6 10.7%	Y154.6 100.0%	
1980 Share	207.9 67.5%	66.7 21.7%	16.6 5.4%	25.2 8.2%	62.0 20.1%	37.4 12.2%	16.9 5.5%	49.0 15.9%	34.1 11.1%	307.8 100.0%	
1981 Share	234.1 67.3%	74.3 21.6%	18.5 5.4%	28.0 8.1%	69.6 20.3%	41.1 12.0%	18.4 5.4%	56.3 16.4%	37.5 10.9%	343.7 100.0%	
1982 Share	252.5 66.4%	80.0 21.0%	19.8 5.2%	30.1 7.9%	78.1 20.5%	44.4 11.7%	21.1 5.5%	64.8 17.0%	42.3 11.1%	380.9 100.0%	
1983 Share	272.2 64.8%	85.4 20.3	21.1 5.0%	32.1 7.7%	86.3 20.5%	47.3 11.3%	23.4 5.6%	74.1 17.6%	50.5 12.0%	420.2 100.0%	
1984 Share	294.2 63.8%	93.2 20.2%	21.6 4.7%	34.6 7.5%	94.0 20.4%	50.7 11.0%	25.1 5.4%	84.6 18.3%	57.1 12.4%	461.0 100.0%	
1985 Share	318.0 63.2%	100.7 20.0%	22.9 4.5%	37.1 7.4%	103.0 20.5%	54.3 10.8%	26.5 5.3%	97.9 19.4%	61.1 12.1%	503.5 100.0%	
1986 Share	339.6 61.3%	109.7 19.8%	23.4 4.2%	39.5 7.1%	109.5 19.8%	57.3 10.3%	27.4 4.9%	116.4 21.0%	70.9 12.8%	554.3 100.0%	
1987: I Share	345.6 55.9%	112.3 18.2%	23.6 3.8%	39.9 6.5%	112.8 18.2%	57.0 9.2%	27.7 4.5%	89.9 14.5%	78.6 12.7%	618.6 100.0%	

Source: Bank of Japan

Table 2: Uses of Japanese Corporate Funds

(in billions of yen and percentage of total)

	Average 1975-79	Average 1980-84	1982	1983	1984	1985	1986
Cash and demand deposits	Y2,509.9 30.5%	Y1,177.8 9.6%	Y1,510.6 12.7%	Y-432.3 -3.5%	Y2,058.4 12.4%	Y1,235.5 4.9%	Y4,808.2 14.2%
Time deposits	3,219.9 39.2%	4,333.4 35.2%	3,971.3 33.3%	6,451.7 52.1%	3,198.8 19.3%	8,791.6 34.5%	10,213.1 30.1%
Certificates of deposits	251.8 3.1%	1,080.8 8.8%	784.2 6.6%	984.1 8.0%	2,273.0 13.7%	758.6 3.0%	696.8 2.1%
Trusts	497.8 6.1%	540.7 4.4%	287.7 2.4%	552.8 4.5%	1,378.9 8.3%	2,484.3 9.8%	6,697.7 19.8%
Securities	1,049.8 12.8%	2,108.6 17.1%	2,443.2 20.5%	1,903.5 15.4%	1,546.6 9.3%	2,214.3 8.7%	2,340.2 6.9%
Bonds	594.3 7.2%	1,404.9 11.4%	1,570.6 13.2%	1,367.1 11.0%	750.2 4.5%	1,690.9 6.6%	-500.5 -1.4%
Stocks	442.5 5.4%	641.8 5.2%	852.2 7.1%	386.2 3.1%	641.9 3.9%	474.1 1.9%	353.8 1.0%
Investment trusts	13.0 0.2%	62.0 0.5%	20.6 0.2%	150.2 1.2%	154.6 0.9%	49.3 0.2%	2,486.9 7.3%
Foreign credit	689.6 8.4%	3,058.2 24.9%	2,942.9 24.6%	2,915.9 23.6%	6,161.0 37.1%	9,975.6 39.2%	9,134.6 26.9%
Total	8,218.9 100.0%	12,299.4 100.0%	11,939.9 100.0%	12,375.7 100.0%	16,616.7 100.0%	25,459.9 100.0%	33,890.6 100.0%

Source: Bank of Japan

Even among the 34.2 percent engaging in zaitech, 33.4 percent reduced their exposure after the October crash.

On the other side of the coin, it is unclear whether companies have shifted fundraising strategies away from traditional bank borrowing in favor of stock and bond issues as might be expected. According to MOF data on the one hand, nearly two-thirds of the new funds raised by all industries in FY 1980 came from bank borrowings, with stock issues accounting for another 23 percent. By fiscal 1986 the share of bank loans had fallen to 9.1 percent, while stock issues rose to 37 percent and convertible bond issues accounted for another 30 percent. On the other hand, Bank of Japan data show the opposite: loans from private banks have steadily increased their dominance (see Table 3). The figures do show, however, that borrowing from all domestic sources has been stagnant over the past decade, while the share of securities has grown sharply. The surge in foreign currency bond flotations is particularly interesting, perhaps indicating that overseas needs are being met with overseas funding.

- Financial institutions - Driven by the need to offer higher returns, financial institutions have aggressively pursued new opportunities opened by liberalization. While both banks and securities companies are expanding overseas, competition in the home market continues to heat up.

New bank offerings have been fairly successful in attracting deposits. Bank of Japan statistics show that in October 1987 all banks reported Y9.9 trillion (\$79.2 billion) in certificates of deposit compared with Y8.4 trillion (\$67.2 billion) the previous year, Y11.7 trillion (\$93.6 billion) in money market certificates versus Y6 trillion (\$48 billion), large deposits worth Y39.8 trillion (\$318.4 billion), well above the Y14.1 trillion (\$112.8 billion) level of October 1986, and trust accounts up from Y12.2 trillion (\$97.6 billion) to Y13.3 trillion (\$106.4 billion). While debentures continued to play a major role in funding (the total rising to Y37.8 trillion or \$302.4 billion from Y36.2 trillion or \$289.6 billion), convertible bond issues exploded from Y186.8 billion (\$1.5 billion) to Y686.1 billion (\$5.5 billion). All told, liabilities rose from Y421.6 trillion (\$3.4 trillion) in October 1986 to Y459.7 trillion (\$3.7 trillion) a year later.

On the other side of the balance sheet, banks have taken advantage of higher interest rates and rising stock markets. Deposits with other banks were up from Y8.1 trillion (\$64.8 billion) to Y10.5 trillion (\$4 billion) in the year ending October 1987; CD holdings rose from Y392 billion (\$3.1 billion) to Y1.1 trillion (\$8.8 billion); corporate bonds climbed to Y17.3 trillion (\$138.4 billion) from Y16.5 trillion (\$132 billion); stocks went up Y2.8 trillion (\$22.4 billion) for a total of Y15 trillion (\$120 billion); and foreign security portfolios hit Y10.6 trillion (\$84.8 billion), up from Y9.1 trillion (\$72.8 billion).

Securities companies enjoyed strong growth from October 1986 to October 1987, with total assets jumping 43.2 percent to Y25.5 trillion (\$204 billion). While all components rose, margin trading accounts climbed from Y4.5 trillion (\$36 billion) to Y7.2 trillion (\$57.6 billion), with the growth of customer securities holdings rising to Y12.5 trillion (\$100 billion) from Y8.7 trillion (\$69.6 billion). On the liabilities side, the biggest increases were in margin accounts, which went from Y900 billion (\$7.2 billion) to Y1.5 trillion (\$12

Table 3: Sources of Japanese Corporate Funds

(in billions of yen and percentage of total)

	Average 1975-79	Average 1980-84	1982	1983	1984	1985	1986
Domestic borrowings	Y12,381.3 83.9%	Y18,623.1 85.7%	Y19,097.5 84.2%	Y19,174.2 86.6%	Y20,863.3 84.8%	Y23,771.1 81.6%	Y26,295.0 82.6%
Private	10,679.0	16,680.4	16,817.5	17,588.6	19,533.6	22,761.0	25,741.3
Banks	72.3%	76.8%	74.2%	79.4%	79.4%	78.1%	80.8%
	6,184.6	11,318.20	11,835.3	12,489.8	15,167.8	18,914.7	20,654.9
Other	41.9%	52.1%	52.2%	56.4%	61.6%	64.9%	64.8%
	4,494.3	5,362.2	4,982.2	5,098.8	4,365.8	3,846.3	5,086.4
Public	30.4%	24.7%	22.0%	23.0%	17.8%	13.2%	16.0%
	1,702.3	1,942.7	2,280.0	1,585.6	1,329.7	1,010.1	553.7
	11.5%	8.9%	10.1%	7.1%	5.4%	3.5%	1.7%
Securities	2,249.2	3,266.3	3,570.2	2,952.7	4,128.2	4,618.6	5,344.5
	15.2%	15.0%	15.7%	13.3%	16.8%	15.9%	26.8%
Corporate bonds	849.2	680.4	632.5	298.6	857.7	681.9	1,579.7
	5.8%	3.1%	2.8%	1.3%	3.5%	2.3%	5.0%
Stock	1,138.6	1,763.3	2,045.2	1,368.1	1,850.3	1,590.5	1,177.1
	7.7%	8.1%	9.0%	6.2%	7.5%	5.5%	3.7%
Foreign currency bonds	261.3	822.5	892.5	1,286.0	1,420.2	2,346.2	2,587.7
	1.8%	3.8%	3.9%	5.8%	5.8%	8.1%	8.1%
Foreign borrowings	131.1	-165.2	7.6	27.1	-379.6	739.0	202.9
	0.9%	-0.8%	0.0%	0.1%	-1.6%	2.5%	0.6%
Total	14,761.6 100.0%	21,724.2 100.0%	22,675.3 100.0%	22,154.0 100.0%	24,611.9 100.0%	29,128.7 100.0%	31,842.4 100.0%

Source: Bank of Japan

billion), and short-term borrowings, which grew from Y2.7 trillion (\$21.6 billion) to Y3.6 trillion (\$28.8 billion).

Beyond the numbers is a new global strategy. Staff and capital expansion in New York and London has taken place at a rapid rate and is likely to keep on growing. Initially the customers are large institutions and corporations to whom small differences in interest rates mean big money. Japanese firms have established links with Wall Street firms to learn about the American market while offering a window on Japan in return. No less than three (a fourth is pending) Japanese firms are eligible to participate in the primary market for U.S. government securities, an elite circle indeed. Japanese banks are gradually moving into retail operations here, but progress has been slow (see JEI Report No. 3A, January 22, 1988). In Europe Japanese securities firms dominate the Euroyen market and are making steady inroads into the overall market. Japanese firms have taken advantage of "universal" banking laws in Britain, West Germany and Switzerland to gain experience in new fields (security firms in banking and vice versa). Altogether, these actions translate into an aggressive strategy to use the strong yen and Japan's large current account surpluses to build a major presence in global finance.

1988 Preview

It would not be surprising if the Ministry of Finance put its liberalization plans on hold in the face of the global stock market crash and 1987's exchange rate volatility. Instead, it is considering accelerating the process to give companies more elbow room to deal with changing conditions. At present the following changes are planned for this year:

- A full-fledged futures market will be opened in June, although a firm date has not been set. While bond and quasi-stock futures have been introduced, a compromise between banks and securities firms was necessary to allow this development. Unlike New York and London, Japan will have two distinct futures markets. Futures for foreign government bonds and stock indices will be added to the existing yen bond futures market on the Tokyo Stock Exchange. Trading in government bond futures will be based on a fictitious 100-yen standard 20-year bond with a coupon of 6 percent, a minimum face value unit of Y100 million (\$800,000), and maturities of three, six, nine, 12 and 15 months. The new trading instrument will resemble present trading of 10-year bonds in two ways: prices will fluctuate a maximum of Y2 (1.6 cents) a day; and margin rates and broker commissions will be identical (a 3 percent margin on deals of at least Y6 million or \$48,000 and an additional 0.015 percent brokerage fee on transactions of less than Y500 million or \$4 million). A new market for currency, interest rate and other futures will also be created.

In a twist, however, securities firms will be allowed to trade all futures except spot currency options, while bankers will be able to trade in all stock exchange markets but the Tokyo stock futures. This division was maintained to placate the bankers, who consider foreign exchange their territory, and the brokers, who consider stocks their turf. Insurance companies will be given the same trading rights as banks out of consideration for their large foreign holdings.

- Specified trust (Tokkin) accounting rules were eased January 5 to counter bearish sentiment among trust and insurance companies managing the

special trusts. In essence, the government will allow managers to avoid reporting Tokkin losses due to the October 1987 stock market crash.

- The Bank of Japan set new loan guidelines January 14 in an effort to strengthen its control of the money supply. Banks have been raising as much as 40 percent of their new funds on the open market rather than on the call and bill markets where the central bank's influence is strong. Points will be assigned inversely according to the proportion of open market funds raised -- the more the open market is used, the fewer points will accumulate. Each bank's point total will determine its credit line with the central bank, a powerful incentive to reduce open market borrowing.

- City or nationwide commercial banks will be allowed to issue convertible bonds sometime this spring. This is tantamount to issuing long-term debentures, effectively eroding the wall between commercial and long-term credit banks. The change will reduce the cost of borrowing for commercial banks and will allow them to better match asset and liability maturities.

- Following the recommendation of the Financial System Research Council, the Finance Ministry is preparing to allow sogo or mutual banks to change to commercial status, perhaps as early as April. Many of these banks are as large as the regional commercial banks, but the change may trigger a wave of mergers and acquisitions.

- Foreign governments and international organizations such as the World Bank will be allowed to issue yen-denominated bonds in Japan through private placement with a maturity of four years, compared with the current minimum of five years.

- An advisory body to the Justice Ministry has recommended that limits on corporate bond issues be eliminated. Currently the Commercial Law sets ceilings on the amount of straight, convertible and foreign bonds a corporation may have outstanding at any time. The limits may be replaced with simple business performance criteria.

- Foreign companies listed on Japanese stock exchanges will be allowed to issue yen-denominated commercial paper this spring. Foreign reaction to this "samurai" paper has been lukewarm because of restrictive procedures and taxes.

- The Ministry of Finance hopes to introduce legislation to the current Diet session to allow shelf registration of domestic stocks and bonds. In contrast to the present approval system, which takes up to 30 days, shelf registration would allow a firm to make stock or bond offerings up to the registered limit with just one or two days' notice. The faster process will allow equity issuers to take advantage of market developments. The registration would last from one to two years.

- To comply with the Bank for International Settlements' capital ratio guidelines, Japanese banks are expected to offer up to Y2 trillion (\$16 billion) worth of new issues. Market analysts are worried that the domestic and Euro markets will be unable to absorb the funding operations, particularly since the crash.

Farther Down The Road

The incremental approach adopted by the Finance Ministry has so far proved equal to the task of restructuring Japan's financial system without undue chaos, and it will continue to be employed to address some of the problems down the road. For example, the restructuring of the banking industry will be pursued piecemeal, as indicated by the decision to allow mutual banks to switch to commercial bank status. The decompartmentalization of foreign exchange banking is also likely to take place before Finance's advisory committees finish work on the deregulation of trust and long-term credit banking. Although these last two subjects are more sensitive, the step-by-step process is being used to weaken existing laws. The decision to allow nationwide commercial banks to float convertible bonds is a clear erosion of the prerogatives of long-term credit banks.

The adoption of new financial regulations and standards will also be addressed on an ad hoc basis. Moves to regulate the investment advisory industry and crack down on insider trading clearly indicate that MOF prefers to deal with problems as they arise rather than try and restrict activities before the fact. This is not the same as laissez faire, however. The quick action to address the need for new accounting and capital ratio standards is a clear message that rules will be imposed when and where necessary.

But some major issues are likely to prove difficult to resolve incrementally. A prime example is the complete deregulation of interest rates paid on deposits. With the easy steps taken, MOF now must find a way to extend the popular deregulation program to small deposits (less than Y10 million or \$80,000) (see Table 4). This step affects not only private financial institutions but the giant postal savings system as well. The Ministry of Posts and Telecommunications is eager to join the liberalization process -- but on its terms. Postal officials want to offer money market certificates in units as small as Y100,000 (\$800), well below the current Y10 million (\$80,000) level and easily within the reach of all savers. This is too drastic in the opinion of the Finance Ministry and private banks; the cost of deposits would skyrocket since banks would have to offer a similar instrument. And the postal savings system would become a tremendously powerful competitor, a development that neither banks nor securities firms relish. The Ministry of Finance has countered by suggesting a gradual reduction of the minimum denomination coupled with an interest rate pegged well below the return on larger certificates and other market-rate instruments. The battle between the two powerful ministries is likely to result in much more freedom for the postal savings system, but at a slower pace than postal authorities would like. From the Finance Ministry's viewpoint, however, the changes will be abrupt compared to previous reforms.

Amending Article 65 of the Securities and Exchange Law is the second problem. Modeled after the U.S. Glass-Steagall Act, the law separates commercial banking and securities operations. While the government favors substantially reducing the barriers between these two fields, it is under heavy pressure from bankers and brokers. Both want access to the other's business but jealously guard their own privileges, although banks are more interested in opening brokerage firms than vice versa. The stock market boom and greater freedom to offer innovative investments has meant record profits for the securities industry -- profits brokers are understandably reluctant to share.

Table 4: Trends in Market-Rate Bank Deposits in Japan

(in billions of yen and percentage share)

	Total Deposits*	Large Time Deposits	Money Market Certificates	Non-Residents' Yen Deposits	Market-Rate Deposits			Certificates of Deposit	Total	Share
						Foreign Currency Deposits				
1975	Y92,921.3	--	--	[Y2,591.7]		100.0%	--	--	Y2,591.7	2.8%
1980	152,978.3	--	--	1,137.9		6,577.0	Y1,931.1		100.0%	
1981	171,418.5	--	--	11.8%		68.2%	20.0%		9,646.0	6.3%
1982	183,576.8	--	--	1,260.0		7,863.0	2,674.0		100.0%	
1983	199,507.9	--	--	10.7%		66.7%	22.7%		11,797.0	6.9%
1984	218,242.0	--	--	1,337.0		8,953.1	3,581.1		100.0%	
1985: I	227,701.8	--	--	9.6%		64.5%	25.8%		13,871.2	7.6%
II	225,649.9	--	--	1,349.3		11,622.8	4,612.4		100.0%	
III	235,407.7	--	--	7.7%		66.1%	26.2%		17,584.5	8.8%
IV	238,581.5	--	--	1,987.9		13,934.4	7,210.7		100.0%	
1986: I	247,360.7	--	--	8.6%		60.2%	31.2%		23,133.0	10.6%
II	244,185.3	--	--	2,050.6		16,205.1	7,188.2		100.0%	
III	255,127.4	--	--	8.1%		63.7%	28.3%		25,443.9	11.1%
IV	258,948.5	--	--	1,947.7		14,904.8	9,273.2		100.0%	
1987: I	371,948.9	--	--	6.8%		52.3%	32.5%		28,510.5	12.6%
II	272,591.2	--	--	2,408.8		17,415.2	8,577.1		100.0%	
III	280,773.5	--	--	7.7%		55.6%	27.4%		31,335.1	13.3%
IV	39,824.5	--	--	2,413.7		18,021.5	7,979.6		100.0%	
1988: I	44,466.4	--	--	6.3%		47.3%	20.9%		38,108.7	16.0%
II	46,666.4	--	--	2,350.6		17,875.8	8,215.0		100.0%	
III	48,666.4	--	--	6.3%		47.7%	21.9%		37,514.2	15.2%
IV	50,666.4	--	--	1,998.6		17,922.5	8,806.5		43,558.6	17.8%
1989: I	55,127.4	--	--	4.6%		41.1%	20.2%		100.0%	
II	58,948.5	--	--	1,965.5		19,886.5	7,442.1		48,356.3	19.0%
III	61,948.9	--	--	4.1%		41.1%	15.4%		100.0%	
IV	64,948.9	--	--	1,783.6		18,744.3	8,445.8		53,269.7	20.6%
1990: I	68,948.9	--	--	3.3%		35.2%	15.9%		100.0%	
II	72,591.2	--	--	1,867.8		21,215.3	9,500.0		55,305.9	20.3%
III	76,773.5	--	--	3.4%		38.4%	17.2%		100.0%	
IV	80,824.5	--	--	1,768.8		19,944.2	10,137.7		68,648.2	25.2%
1991: I	84,824.5	--	--	2.6%		29.1%	14.8%		100.0%	
II	88,824.5	--	--	1,891.7		19,641.9	9,915.6		82,952.2	29.5%
III	92,824.5	--	--	2.3%		23.7%	12.0%		100.0%	

*Deposits from all sources plus certificates of deposit.

Source: Bank of Japan

Finance has tried to placate both sides by giving each something at every step of the reform process. Particularly in the case of new markets, it has given both groups equal or equivalent access. Even where this compromise has worked, as in the proposed financial futures markets for example, the ministry has had to maintain some differences out of deference to Article 65.

Although the ministry has not formally begun to study amending the law, it is watching with great interest the U.S. debate on Glass-Steagall. The fact that Washington has not backed away from reform in the aftermath of the October 1987 stock market crash is seen as encouraging. If the United States should significantly weaken Glass-Steagall, reform of Article 65 will surely follow. Japan's ability to implement the changes gradually, however, is in question. The breaching of this fundamental barrier could easily release a flood of competition that would destabilize domestic markets and begin a shakeout period. Preventing this will be a major challenge to ministry planners.

Financial liberalization has come a fair distance over the past four years -- farther than some expected but less than others hoped. The rapid expansion of Japanese financial institutions has vaulted them into the top global rankings, but they have just begun to meet their potential. Continued reform is the key not only to the growth of Japanese financial institutions abroad but also to the expansion of foreign financial firms in Japan.

For further information, contact Jon Choy.

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The views expressed in this report are those of the author and do not necessarily represent those of the Japan Economic Institute.

JEI

R E P O R T

A Two-Part Report: A and B

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EPA Finds Rapid Employment Gains In Current Expansion

Japanese economic growth has often been associated with increasing exports. Recently it has been different: domestic demand is clearly leading the way. The Economic Planning Agency says that employment, especially in nonmanufacturing, has grown more rapidly as a result.

EPA compared the current recovery and expansion, which it dates from November 1986, with the previous one running from February 1983 to March 1984. In many respects the expansions are similar: industrial output increased by 10.7 percent during the earlier period and 12 percent during the second. The gross national product grew at a healthy rate during both periods, although monthly data that would permit direct comparisons are not available.

The biggest single difference is trade. In the earlier expansion, the yen was practically stable (rising just 4.8 percent) and the current account surplus was growing. In the more recent period, the yen appreciated 26.7 percent and the monthly current account surplus rose and then fell, ending up generally lower.

EPA looked at the pattern of employment expansion during the two periods. The current one is clearly more favorable, even in the hard-pressed manufacturing sector (see Table). While the growth in the labor force (those available for work) was about the same in both periods, employment is growing far faster in the current rebound.

Comparing Two Expansions

(growth in number of people)

	<u>February 1983-March 1984</u>	<u>November 1986-December 1987</u>
Increase in Labor Force	220,000	280,000
Increase in Total Employment*	740,000	1,160,000
Manufacturing	350,000	370,000
Wholesale, Retail, and Eating and Drinking Establishments	60,000	480,000
Services	250,000	500,000

*Employees only. Does not include self-employed people or family workers. The sectoral figures, however, cover all three categories of workers.

Source: Management and Coordination Agency

Other data are supportive of the same conclusion. The ratio of job openings to applications has improved since November 1986 from 0.61 to 0.85, a gain of 0.24, while in the earlier period it increased only 0.06 from 0.58 to 0.64.

EPA sees these results as encouraging for the ability of the Japanese economy to continue growing, barring further shocks. More generally, they are consistent with a shift toward employment in nonmanufacturing industries that transcends both the current business cycle and national boundaries. If the shift has been relatively slow in Japan, it no longer is.

Douglas Ostrom

Japan's Balance Of Payments Edged Up In 1987

Those attempting to determine the direction of Japan's balance of payments had a harder job than usual last year. The country's current account and trade surpluses in dollar terms rose slightly in 1987 to set new records for the fifth straight year. In yen terms the surpluses fell substantially, and an

alternative measure of the trade balance in dollars showed a small drop (see JEI Report No. 4B, January 29, 1988).

The confusion arises in part because of the fluctuating yen. As it appreciated against the dollar, quantities of exports, which actually fell 1.7 percent during 1987, were up in dollar terms. Although import volume rose 7.4 percent, the trade surplus as measured in dollars increased (see Table 1).

Table 1: Japan's Balance of Payments

(in millions of dollars, IMF value basis)

	<u>1983</u>	<u>1984</u>	<u>1985</u>	<u>1986</u>	<u>1987*</u>
Current Account	\$20,799	\$35,003	\$49,169	\$85,845	\$86,688
Trade Balance	31,454	44,257	55,986	92,827	96,464
Exports (f.o.b.)	145,468	168,290	174,015	205,591	224,432
Imports (f.o.b.)	114,014	124,033	118,029	112,764	127,968
Services	-9,106	-7,747	-5,165	-4,932	-6,099
Transfers	-1,549	-1,507	-1,652	-2,050	-3,677
Long-Term Capital	-17,700	-49,651	-64,542	-131,461	-137,127
Basic Balance	3,099	-14,648	-15,373	-45,616	-50,439
Short-Term Capital	23	-4,295	-936	-1,609	23,845
Errors and Omissions	2,055	3,743	3,991	2,458	-2,951
Overall Balance	5,177	-15,200	-12,318	-44,767	-29,545

*Preliminary.

Source: Bank of Japan

A month-to-month comparison with the previous year also shows the effect of the turmoil in the currency markets. After rising for the first four months of 1987, the dollar-denominated current account was lower every month compared to the same period a year earlier for seven straight months, slightly reversing course only in December. The falling surpluses in the middle of the year occurred when the dollar was comparatively stable and reflected the yen's earlier appreciation; rising surpluses at the beginning and end of the year showed the short-term adverse J-curve effect of a rising yen during those periods.

While the current account surplus overall did not change much in 1987, some of its components did. Investment income rose 76 percent to \$16.7 billion but was more than offset by the deficits in other services such as travel, which widened in response to the strong yen. The increase in the overall services deficit reversed a pattern of recent annual decreases.

Japan's net long-term capital outflow continued at a high level, reflecting the recycling of current account surpluses to overseas financial markets (see Table 2). Direct investment increased 35 percent as Japanese companies continued to move production offshore in response to the strong yen. Companies from the United States and elsewhere substantially increased their rate of direct investment in Japan as well, but the amounts were far smaller.

Table 2: Net Long-Term Capital Flows

(in millions of dollars)

	<u>1986</u>			<u>1987*</u>		
	<u>Outflows</u>	<u>Inflows</u>	<u>Net</u>	<u>Outflows</u>	<u>Inflows</u>	<u>Net</u>
Direct Investment	\$-14,480	\$226	\$-14,254	\$-19,488	\$1,165	\$-18,323
Trade Credits	-1,836	-40	-1,876	-613	-1	-614
Loans	-9,281	-34	-9,315	-16,703	-119	-16,822
Securities	-101,977	545	-101,432	-87,798	-6,074	-93,872
Stocks	-7,048	-15,758	-22,806	-16,874	-42,835	-59,709
Bonds	-93,024	-2,109	-95,133	-72,885	6,675	-66,210
Yen-Denominated						
Bonds Issued in						
Japan	-1,905	n.a.	-1,905	1,961	n.a.	1,961
External Bonds**	n.a.	18,412	18,412	n.a.	30,086	30,086
Other	-4,521	-63	-4584	-8,830	1,334	-7,496
Total	-132,095	634	-131,461	-133,432	-3,695	-137,127

Note: A negative sign indicates a capital outflow.

*Preliminary.

**Bonds issued outside of Japan by Japanese institutions.

Source: Bank of Japan

The net outflow of securities dropped in 1987, reversing the pattern of rapid increases in recent years. Moreover, the distribution was somewhat different than 1986. American and other investors substantially reduced their position in Japanese stocks both before and after Black Monday. This action, which has the same effect on the balance of payments as increasing Japanese investment abroad, accounted for about 31 percent of the net long-term capital outflow.

The withdrawal of foreign investors from the Tokyo market is unlikely to continue and already shows signs of reversing; without it the recycling process is likely to get more difficult. While government intervention in currency markets may help for a while, over a longer period either the Japanese current account will shrink, reducing the need for a net Japanese capital outflow, or Japanese investors will have to be stirred to greater participation in overseas securities markets, perhaps with higher interest rates in the United States.

Generally, however, the net long-term capital outflow highlights the continued importance of Japanese purchases of bonds overseas, especially in the United States. In 1987 net purchases totaled almost \$73 billion, down from \$93 billion the year before but still accounting for most of the recycling of Japan's current account surplus. The numbers suggest that the Japanese have not abandoned foreign capital markets, although their enthusiasm may be waning.

Douglas Ostrom

Update On Sino-Japanese Relations

Relations between Beijing and Tokyo experienced several bumps on a generally upward road in 1987. While Sino-Japanese trade continued to move toward balance, repercussions from the Toshiba Machine Co., Ltd. diversion created a sensitive trade problem. Beijing's unhappiness with an Osaka court decision favoring Taiwan also continued to trouble harmonious relations. Both sides are trying to take advantage of Noboru Takeshita's election as prime minister to smooth ruffled feathers and to coordinate foreign policy in the Korean peninsula, an area of immediate and mutual interest.

According to Ministry of Finance data, Japan's trade surplus with China fell to Y123.3 billion (or just under \$1.3 billion in dollar terms) in 1987, an 82.4 percent drop over the previous year (see Table). Another contraction in exports and solid import growth explained the rapid turnaround. The total volume of trade declined 13.7 percent, however, from Y2,632.4 billion to Y2,272.8 billion. China's economic reform program led to an import surge up through 1985. The resulting jump in the trade deficit and consequent erosion of foreign exchange reserves alarmed Chinese leaders. Beijing clamped down on imports and called on trading partners, particularly Japan, to buy more Chinese exports. The two measures have clearly been effective.

Sino-Japanese Trade, 1983-87

(in millions of yen and thousands of dollars; change from previous year)

	<u>Exports</u> <u>(f.o.b.)</u>	<u>Imports</u> <u>(c.i.f.)</u>	<u>Trade</u> <u>Balance</u>
<u>Yen</u>			
1983	Y1,167,551	Y1,209,149	Y-41,598
	33.9%	-8.8%	90.9%
1984	1,720,803	1,411,271	309,532
	47.4%	16.7%	n.a.
1985	2,991,151	1,552,365	1,438,786
	73.8%	10.0%	364.8%
1986	1,666,511	965,839	700,672
	-44.3%	-37.8%	-51.3%
1987	1,198,085	1,074,761	123,324
	-28.1%	11.3%	-82.4%
<u>Dollars</u>			
1983	\$4,912,334	\$5,087,357	\$-175,023
	39.9%	-5.0%	-90.5%
1984	7,216,712	5,957,607	1,259,105
	46.9%	17.1%	n.a.
1985	12,477,446	6,482,686	5,994,760
	72.9%	8.8%	376.1%
1986	9,856,178	5,652,351	4,203,827
	-21.0%	-12.8%	-29.9%
1987	8,664,693	7,396,862	1,267,831
	-12.1%	30.9%	-69.8%

Source: Ministry of Finance

As a result of illegal shipments of milling machines to the Soviet Union, Toshiba Machine was forced to suspend all trade with communist countries for one year beginning in May 1987 (see JEI Report No. 22B, June 12, 1987). The ban brought an immediate protest from Beijing, which claimed that it was suffering for an affair it had nothing to do with. According to Japanese officials, 25 contracts with China worth approximately Y2.4 billion (\$19.2 million at Y125=\$1.00) were affected. Tokyo could not simply exempt China from its ban, however, without irritating the United States. A compromise plan was mapped out in December that would allow Toshiba Machine to fill about 10 of the contracts but it could not receive any cash payments until after the one-year ban had expired. China would get the goods and Toshiba Machine would still face losses for the year.

Mr. Takeshita addressed China policy during his first question period in the Diet as prime minister, holding to the direction set by his predecessor. In response to questions from the Japan Socialist Party, the prime minister said that the government will maintain a "one China" policy as outlined in the 1972 Japan-China joint communique and the 1978 Japan-China peace and friendship treaty. Referring to a 1987 ruling by the Osaka High Court that reversed a lower court decision that China and not Taiwan owned a student dormitory, Mr. Takeshita said that it was inappropriate for the government to intervene in the case, which is on appeal to Japan's Supreme Court. Beijing considers the Osaka High Court decision to contravene the "one China" policy, and Tokyo has been embarrassed by the case.

Tensions in the Korean peninsula are of vital concern to both nations and working-level talks between Deputy Foreign Minister Takakazu Kuriyama and Vice Minister Liu Shuqing January 28-29 in Beijing focused mainly on this issue. This month's inauguration of Roh Tae Woo as South Korean president was discussed, with Japan pledging to help the transition to a full democracy in any way. Both sides expressed hope that the Summer Olympics in Seoul would be peaceful.

In connection with these two subjects, relations between Seoul, Beijing and Pyongyang were discussed. North Korea will boycott the Seoul games, while China (and the Soviet Union) are almost certain to attend. This plus the charges that North Korea was behind the November 1987 bombing of a South Korean airliner (see JEI Report No. 5B, February 5, 1988) have raised tensions on the peninsula. The South Korean president-elect has publicly indicated his interest in normalizing relations with China. Beijing, on the other hand, will not take such a step for fear that it will worsen relations with North Korea and increase Soviet influence north of the 38th parallel. Tokyo denies that it is trying to act as a go-between for Beijing and Seoul but such a role would seem natural.

Preparations for Mr. Takeshita's first visit to China as prime minister were also laid during the January talks. The 10th anniversary of the peace treaty on October 23 presents an ideal opportunity for a visit and Chinese authorities responded positively to the suggestion. Both Beijing and Tokyo are clearly taking steps to smooth relations. If this becomes the foundation for diplomatic cooperation, the entire region could benefit.

Jon Choy

Republican indicated in unequivocal terms that he would not bend. "This amendment alone has caused more changes in [Japan's and other countries'] laws than just jawboning," he told the group, which was comprised of a broad cross section of business, government, congressional, diplomatic and academic representatives. "Without a [monetary] incentive, we won't see the types of improvements in export control that we need," Sen. Garn declared.

The Utah Republican also indicated that he is not inclined to excuse parent Toshiba on the grounds that the parent should bear ultimate responsibility for the behavior and activities of its subsidiaries -- "just as I bear ultimate responsibility for what my staff does." Sen. Garn dismissed questions concerning the fairness of establishing penalties for prospective violators, contending that it provides a necessary incentive for companies to proceed with extreme care in the future. "If you don't violate the law, you won't get hit -- it's that simple," he explained.

Although a representative from the Japanese Embassy effectively articulated all that Japan has done to prevent a replay of the Toshiba Machine affair -- such as lengthening prison terms for violators, extending the statute of limitations, beefing up its export screening staff, and assigning more export control specialists to key diplomatic posts (see JEI Report No. 35B, September 18, 1987) -- Sen. Garn nevertheless lashed out at this country's most important Asian ally. The government of Norway has still done more than Japan in terms of corrective actions, he charged.

Barbara Wanner

Tokyo Extends Car Export Restraints For Eighth Year

Going by the record, International Trade and Industry Minister Hajime Tamura's January 29 announcement that exports of Japanese-made cars to the United States would remain capped at 2.3 million units through March 1989 should have been a major story in this country and Japan. It was anything but. The reason was simple: given the way the political winds are now blowing on Capitol Hill and Tokyo's attempt to play it safe for the last three years and keep the restraints in place even though the White House had not requested an extension, the media on both sides of the Pacific had written off the announcement as a foregone conclusion.

But extending the shipment limits for an eighth year was not a cut-and-dried decision. As Mr. Tamura acknowledged, there was significant support within MITI for the elimination of the quotas when they expire at the end of March. Whatever economic rationale underpinned the 1981 bilateral agreement to shelter American automotive manufacturers from the full brunt of Japanese competition has long since disappeared, this faction stressed. The pro-elimination group also maintained that 1988 would be a good year to return to unrestricted trade in cars because there was no chance of a surge in shipments. On the contrary, the same combination of factors that trimmed U.S. sales of made-in-Japan cars in 1987 (see Table) -- softer domestic demand, higher sticker prices for Japanese nameplates, Detroit's aggressive use of incentives, more competition from other offshore suppliers in the market's low end and bigger supplies of Japanese models assembled in the United States -- would hold down exports this year.

U.S. Retail Car Sales, 1982-87

Manufacturer/Seller	(units)					
	<u>1982</u>	<u>1983</u>	<u>1984</u>	<u>1985</u>	<u>1986</u>	<u>1987</u>
Toyota Motor Corp.	530,246	555,766	557,981	620,047	633,914	585,199
Honda Motor Co., Ltd.*	365,865	350,670	374,819	406,413	458,268	421,688
Nissan Motor Co., Ltd.	470,246	521,902	485,298	535,372	494,294	409,476
Mazda Motor Corp.	163,638	173,388	169,666	211,093	222,716	206,354
Fuji Heavy Industries, Ltd. (Subaru)	150,335	156,840	157,385	178,175	179,100	175,864
Mitsubishi Motors Corp.	3,950	32,755	39,104	49,734	49,436	67,954
Isuzu Motors Ltd.	15,462	20,731	17,233	26,953	38,910	39,577
Mitsubishi Motors Corp./Chrysler Corp.	102,227	103,569	91,718	105,213	135,528	120,337
Isuzu Motors Ltd./General Motors Corp.	0	0	2,077	53,593	99,380	76,852
Suzuki Motor Co., Ltd./General Motors Corp.	0	0	10,927	31,267	60,983	60,359
General Motors Corp.**	3,515,660	4,053,561	4,587,508	4,607,458	4,532,798	3,555,538
Ford Motor Co.	1,345,698	1,571,321	1,979,317	2,070,392	2,066,507	2,019,783
Chrysler Corp.	691,703	841,622	986,998	1,139,936	1,173,463	962,057
American Motors Corp.	112,433	193,351	190,255	123,449	72,848	***
Volkswagen of America Inc.	91,166	85,045	73,838	77,535	73,912	61,064
Honda of America Manufacturing, Inc.	0	50,402	133,601	145,976	235,247	316,618
New United Motor Manufacturing Inc./General Motors Corp.	0	0	0	35,594	170,507	134,956
New United Motor Manufacturing Inc./Toyota Motor Sales USA Inc.	0	0	0	0	7,281	44,853
Nissan Motor Manufacturing Corp. U.S.A.	0	0	0	39,794	52,602	119,678
Mazda Motor Manufacturing (USA) Corp.	0	0	0	0	0	1,671
Total Japanese Imports	1,801,969	1,915,621	1,906,208	2,217,860	2,372,529	2,163,660
Total Imports	2,221,398	2,382,799	2,439,848	2,841,063	3,235,343	3,145,326
Total Domestic Makes	5,756,660	6,795,302	7,951,517	8,204,721	8,214,658	7,081,262
Total Market	7,978,058	9,178,101	10,391,365	11,041,784	11,450,001	10,226,588
Market Share of Japanese Imports	22.6%	20.9%	18.3%	20.1%	20.7%	21.2%

*Includes 52,869 Acuras in 1986 and 109,470 in 1987.

**Starting in 1985 includes the Nova made by New United Motor Manufacturing Inc.

***Chrysler Corp. took over American Motors Corp. in 1987.

Source: Automotive News

MITI officials also considered a third option -- keeping the restraints but lowering the export ceiling for the April 1988-March 1989 period. This course of action would have earned Japan much-needed points on Capitol Hill while costing exporters few if any sales. But Japanese policymakers were not anxious to give the appearance that they had finally bowed to American demands for a shipment rollback, particularly since Ford Motor Co., Chrysler Corp. and the United Auto Workers union base their campaign for a smaller quota on the growth of Japanese car output in the United States. Why should Japanese motor vehicle manufacturers be penalized at all for having accepted Detroit's challenge to produce where they market? Industry executives and government leaders asked not for the first time.

MITI Minister Tamura candidly described the decision to continue the restraints at the current level of 2.3 million vehicles as political. But some American trade and industry analysts wonder whether the move really was smart politics because it could have the perverse effect of boosting Japan's U.S.-bound car exports in February and March. They reason that without an extension most exporters would have reduced shipments to trim their big U.S. inventories, in the process helping to narrow the yawning bilateral trade deficit. Afraid now that MITI will reallocate part of their quota for the April 1988-March 1989 period if they do not fill FY 1987's allotment, the argument goes, these manufacturers will ship their full share of cars by March 31 regardless of U.S. sales results.

While some trade and industry watchers dispute MITI's prediction that shipments in the current fiscal year will be below the 2.3 million level, there is general agreement that FY 1988 exports will fall short of the ceiling. This projection is built on the assumption that Japanese automotive manufacturers will bring domestic supplies into line with weakening demand by adjusting exports to the extent possible rather than tinkering with U.S. production plans.

Toyota Motor Corp. will start turning out a Camry-class car this spring at its recently completed Georgetown, Kentucky plant, while Diamond-Star Motors Corp., the Bloomington, Illinois joint venture between Mitsubishi Motors Corp. and Chrysler, will launch production of a sports coupe for its two parents this fall. About that time Mazda Motor Corp.'s Flat Rock, Michigan plant, which assembled only 4,300 cars in 1987, should reach full capacity, making the sporty MX-6 for Mazda and the similar Probe for Ford at an annual rate of 240,000 vehicles.

In addition, Nissan Motor Co., Ltd. would like to raise Sentra output at its Smyrna, Tennessee facility above 1987's tally of 113,000, although this will depend on U.S. demand for its pickups, all of which are now built here. For its part, Honda Motor Co., Ltd. plans to up the number of Accords and Civics rolling off its Marysville, Ohio assembly lines from 322,000 to 360,000 this year. New United Motor Manufacturing Corp. also has the capacity at its Fremont, California plant to expand the output of Toyota Corollas beyond 1987's total of 42,000, but overall production is expected to drop from 182,000 to somewhere between 120,000 and 150,000 in 1988 because of reduced demand for the Chevrolet Nova.

By triggering a cutback in exports, increased U.S. output of Japanese nameplates could hasten a decision by Tokyo to scrap the shipment limits.

MITI Minister Tamura told a press conference that the quotas would be removed when the decline in U.S.-bound shipments becomes an "established trend." Most observers do not expect the government to take this step until March 1989, but if there is a big drop in exports this spring and summer, the era of managed trade in cars could end soon after the November elections.

Susan MacKnight

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The views expressed in this report are those of the authors and do not necessarily reflect those of the Japan Economic Institute.

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J E I

R E P O R T

A Two-Part Report: A and B

NO. 7B
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Wage Talks Begin In Earnest

Although a new player is taking part in this year's shunto, or spring wage offensive, labor's ritual demands and management's familiar responses are identical to earlier years. The major labor unions hope to win wage hikes of 5 to 7 percent. Management, on the other hand, argues that international competitive pressures make any increase other than the ordinary adjustment for inflation impossible.

Since the late 1950s the shunto process has been seen as an effective way to maximize labor's strength. Coordinating individual unions (which are company-specific) and labor associations to demonstrate and handle negotiations and strikes countered management's strong position (see JEI Report No. 2A, January 15, 1988). Traditionally, the unions announced their demands in December

Although the Japanese economy is humming along, most observers expect management to successfully hold the line on wage increases again this year. While Tokyo is concerned that this might endanger the healthy consumer spending that is vital to its economic restructuring plans, the Ministry of Labor has proved unable to influence management in past shuntos.

Jon Choy

High Yen Hurts Japanese Competitiveness In High Technology

In a reversal of recent trends, a report by the Japan Development Bank, a government-affiliated financial institution, suggests that the United States has increased its ability to compete with Japan in high technology products as a result of the doubling in the yen's value since 1985. While American technology in many industries equals or betters Japan's, the strength of the dollar in the first half of the 1980s made it difficult for U.S. manufacturers to match Japanese prices. But at the current exchange rate of about 130 yen to the dollar, the two countries are roughly competitive, and at 120 yen to the dollar, a level reached earlier this year, the United States would have a slight lead.

High technology goods were defined using the Commerce Department definition of products whose direct and indirect research and development costs exceed 5 percent of the sale price. Using an exchange rate of Y140=\$1.00, output in Japan totaled \$282 billion in 1985 and \$432 billion in the United States. The study found that high technology employment and output were increasing rapidly in both countries over the 1977-85 period while other manufacturing employment was declining. High technology industries were increasing their share of total manufacturing employment and output faster in the United States.

The recent increase in U.S. competitiveness reversed several years of deterioration caused by a strong dollar and a widening gap in high technology unit labor costs. Taking 1977 as the base, these costs in the United States had risen 30 percent by 1985, while dropping 28 percent in Japan. However, the trend of unit labor costs in both countries was much more favorable in high technology fields than in other areas of manufacturing, although the difference was more pronounced in the United States. This suggests that, with the right exchange rate, high technology industries have more potential to expand net exports than do other U.S. industries.

Because unit labor costs were generally falling in Japan and rising in the United States in the first half of the 1980s, an average exchange rate of about Y148=\$1.00 would have been necessary for competitive equality in 1985 when the actual exchange rate was about Y239=\$1.00. As a result, Japan's trade surplus in this sector widened, reaching a level of \$8.9 billion with the United States in 1985 (see Table). Recently the equilibrium rate by the bank's reckoning has moved toward Y130=\$1.00. If the yen appreciates, the U.S. competitive position would be enhanced.

Douglas Ostrom

Japan-U.S. Trade in High Technology Products

(in millions of dollars)

	<u>1980</u>	<u>1984</u>	<u>1985</u>	<u>1986</u>
Japan's exports	\$6,087	\$15,921	\$16,413	\$20,607
Japan's imports	4,549	7,263	7,467	7,867
Bilateral balance	1,538	8,658	8,946	12,740

Reference:

Japan's global balance
in high technology 17,326 29,851 31,408 40,455

U.S. global balance
in high technology 26,697 6,046 3,647 -2,590

Note: For both countries, imports are valued c.i.f. Japanese export figures are f.o.b., while the U.S. export numbers are f.a.s.

Source: Japan Tariff Association, Japan Exports and Imports; U.S. Department of Commerce.

Tensions Mount Over Japan-South Africa Trade

Congressional discontent over U.S.-Japan trade disputes has crystallized into yet another area of complaint: Japan's trade with South Africa. There has been some publicity recently concerning the fact that in 1986 Japan replaced the United States as South Africa's largest trading partner. That the dollar value of two-way trade soared again in 1987 to \$4.3 billion (see Table 1) -- a 19.3 percent increase -- has only served to highlight the issue.

Table 1: Japan's Trade with South Africa in Dollar Terms, 1982-87

(in millions of dollars)

	<u>1982</u>	<u>1983</u>	<u>1984</u>	<u>1985</u>	<u>1986</u>	<u>1987</u>
Exports	\$1,654.7	\$1,738.0	\$1,839.9	\$1,019.9	\$1,355.2	\$1,862.5
Imports	1,840.2	1,587.3	1,610.6	1,843.9	2,228.7	2,412.3
Trade balance	-185.5	150.7	229.3	-824.0	-873.5	-549.8
Total trade	3,494.9	3,325.3	3,450.5	2,863.8	3,583.9	4,274.8
Percent change	--	-4.9%	3.8%	-17.0%	25.1%	19.3%

Source: Japan Tariff Association, The Summary Report: Trade of Japan

Several legislators as well as the Congressional Black Caucus have criticized Japan's trade relations with South Africa, claiming that it is undermining U.S. attempts to change Pretoria's apartheid policy through the imposition of economic sanctions. Consequently, rumors of retaliatory legislation have been receiving more and more attention on Capitol Hill recently. Indeed, legislators have already paved the way for punitive action. When Congress approved an anti-apartheid sanctions package in 1986, it provided for retaliation against any country that benefited from the sanctions by taking up where U.S. industry left off. The provision has not yet been invoked, but some lawmakers are reportedly considering the possibility of attaching Japan-specific punitive measures based on the clause to HR 3, the trade bill now pending in a House-Senate conference committee.

Congressional spokesmen may be overstating their case, however. Although the dollar value of Japan's trade with South Africa skyrocketed during the past two years, most of the increase was the result of the appreciation of the yen. In yen terms trade actually decreased substantially in three of the last five years; in 1987 it did increase -- but only by a slight 2.1 percent (see Table 2).

Table 2: Japan's Trade with South Africa in Yen Terms, 1982-87

	(in billions of yen)					
	<u>1982</u>	<u>1983</u>	<u>1984</u>	<u>1985</u>	<u>1986</u>	<u>1987</u>
Exports	Y408.5	Y413.3	Y434.4	Y244.6	Y228.4	Y269.1
Imports	455.8	377.0	381.6	441.9	378.7	350.7
Trade balance	-47.3	36.3	52.8	-197.3	-150.3	-81.6
Total trade	864.3	790.3	816.0	686.5	607.1	619.8
Percent change	--	-8.6%	3.3%	-15.9%	-11.6%	2.1%

Source: Japan Tariff Association, The Summary Report: Trade of Japan

Nonetheless, several publications have reported that Ministry of Foreign Affairs officials are uncomfortable with the figures -- even more so in light of the attention focused on the issue in Washington. Business Week quoted one ministry official as saying "These figures seriously embarrass me. We've put pressure on companies to decrease trade, but the final decision is up to them." Japan imports a variety of industrial and agricultural inputs from South Africa, including platinum, chrome, asbestos, manganese, vanadium, coal and corn. It is an important supplier to that country as well, selling primarily cars and electronic equipment. Foreign Minister Sosuke Uno has publicly requested businesses to exercise more self-restraint in trading with South Africa, as have the Ministry of International Trade and Industry and the Federation of Economic Organizations (Keidanren).

And in fact, Tokyo has approved a series of measures to protest apartheid. Relations between the two countries exist only at the consular level. The government has banned direct foreign investment in South Africa, forbidden

the export of computers to government agencies, ended purchases of the Krugger-rand gold coin, and refused to participate in athletic, cultural or educational exchanges with that country. Tokyo also has a scholarship program for black South African students, and has instructed Japanese firms with operations in the region to give black employees the same working conditions as whites.

In September 1986 the government added additional sanctions to the list. It banned future steel purchases from South Africa, suspended tourist visas for South Africans, moved to limit Japanese tourism in South Africa and prohibited the use of South African Airways' international flights by Japanese government employees. Reciprocal landing rights between the two countries were also officially suspended, although this was largely a symbolic gesture since there had been no chartered flights between the two countries in some 20 years nor any agreement on scheduled service.

Critics are far from satisfied, however, claiming that the private sector can easily circumvent the ban on foreign investment by using third-country intermediaries. Allegations that the ban on computer sales has been ineffective have also appeared. What could be more damaging to U.S.-Japan relations, though, is the more general perception that Japan has benefited economically from U.S. policy toward South Africa. It would take just a small congressional step to translate this perception into a retaliatory amendment to HR 3.

Eileen M. Doherty

Interim Agreement Reached On Bilateral Science And Technology Pact

On February 1 Japan and the United States agreed in eleventh-hour discussions to extend their Science and Technology Agreement until the end of March as a stop-gap measure. Negotiators still appear far apart on key points concerning reciprocal participation in government-funded research and development programs, but to avoid interrupting existing joint research, both countries decided that it was in their mutual interest to maintain the existing accord temporarily -- however outdated and inadequate it has become -- rather than allow it to lapse on January 31.

From the U.S. viewpoint, the 1980 accord is so vague that it has enabled Japan to easily exploit American university R&D programs in leading-edge technologies, while at the same time severely restricting U.S. participation in many Japanese industrial efforts. This, in turn, has allowed Japan to improve its competitive position in certain industries at the United States' expense, the argument goes.

Last fall the late Commerce Secretary Malcolm Baldrige raised this issue at the cabinet-level Economic Policy Council and urged that the one-way relationship be rectified through negotiations to renew the accord. This more detailed agreement would not only set the stage for future cooperative research in specific emerging industries, such as advanced materials, biotechnology and superconductivity, but more importantly, establish a new comprehensive policy framework -- or "umbrella" -- for overall science and technology relations between the two countries. This was viewed as particularly important and timely in view of Japan's planned participation in research related to the Strategic

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R E P O R T

A Two-Part Report: A and B

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FY 1988 OUTLOOK FOR THE JAPANESE ECONOMY

Summary

Since early 1985 the yen has more than doubled in value. As expected it has led to fewer exports, more imports and increased purchasing power for Japanese consumers, although all these effects have come more slowly than anticipated.

In the past the Japanese economy has often grown in the face of declining demand from abroad, but this time the yen's appreciation came after several years of booming exports and the adjustment was expected to be difficult. While far from painless, the process has been less traumatic than many expected. In fiscal year 1987, which ends March 31, 1988, inflation-adjusted growth may well reach 4 percent, exceeding the government's 3.7 percent estimate issued only two months ago.

The continued appreciation of the yen in November and December suggests the adjustment process will continue into FY 1988, with rising domestic demand again offsetting declining net exports. Inflation will remain low, reflecting in part the yen's continued strength.

The Economy in FY 1987

A year ago Japanese policymakers and industrial leaders were fairly pessimistic. During FY 1986 the yen had appreciated against the dollar by 38.3 percent. While exports had fallen some in volume, there was a strong sense that much of the adjustment was still to come. Domestic demand was expected to increase during the April 1987-March 1988 period but falling net exports would

bring the growth rate down significantly. The government estimated that the external component would contribute -0.5 percent and the domestic component 4 percent to the expected real growth rate of 3.5 percent, assuming an exchange rate of 163 yen to the dollar. Private forecasters on average were not nearly as optimistic, predicting only a 2.4 percent increase in inflation-adjusted gross national product (see JEI Report No. 6A, February 13, 1987) with the yen at 150 to 170 to the dollar.

The government's revised estimate for the 1987 fiscal year reflects the unexpected changes that have occurred in currency markets. The yen is now expected to average Y140=\$1.00 for the April 1987-March 1988 period, or close to the figure for the first 10 months of the fiscal year. Since the yen has appreciated so much, the external sector's drag on the economy is correspondingly greater, now put at -1.3 percent (see Table 1). In spite of this, the projected real growth rate is 3.7 percent, up 0.2 percentage point from the original outlook, as a result of stronger than expected domestic demand, which is expected to grow by 5 percent through March 31.

Table 1: Components of Japan's Real Economic Growth

	<u>Total</u>	<u>Domestic</u>		<u>External Component</u>
		<u>Private</u>	<u>Public</u>	
FY 1981	3.3%	1.5%	0.5%	1.2%
FY 1982	3.2	2.6	0.1	0.5
FY 1983	3.7	1.9	0.2	1.5
FY 1984	5.1	3.7	0.2	1.3
FY 1985	4.4	4.0	-0.3	0.8
FY 1986	2.6	2.8	1.3	-1.5
FY 1987*	3.7	4.4	0.6	-1.3
FY 1988**	3.8	4.5	0.3	-1.0

*Calculated from government growth estimate.

**Calculated from government outlook.

Source: Economic Planning Agency

The FY 1987 results have been affected by a number of important developments. In February, two months after the government released its forecast, the Group of Seven industrial nations met in France and ironed out what became known as the Louvre Accord, essentially committing the participants to maintain exchange rates at close to existing levels. Although at first the agreement appeared to be working, it may have contributed to the unsettled conditions in the fall when global equity markets dropped dramatically and the yen resumed its rapid ascent. In any case, the unprecedented stock market crash left analysts wondering about the long-term impact, especially on American consumer and corporate spending plans.

As part of the Louvre Accord, Japan took major steps to expand its economy. The discount rate was lowered in February to an all-time-low 2.5 percent and has stayed there. Other interest rates, helped by a continuing expansionary monetary policy, followed it down. The government began implementing a Y6 trillion (\$48 billion at Y125=\$1.00) supplemental fiscal stimulus package that emphasized public works but also included an estimated Y1.5 trillion (\$12 billion) in personal income tax cuts. These monetary and fiscal measures contributed to an expansion of domestic demand that more than offset the decline in the external sector.

The trade imbalances of the United States and Japan continue to dominate discussions among major trading countries. Both the surplus in Japan and the deficit in the United States are seen as unresponsive to exchange rate changes or other policy measures. In fact, the FY 1987 outlook for the Japanese economy underestimated the drop in the current account surplus. Originally projected at Y12.5 trillion, the government now sees a surplus of Y11.5 trillion.

The Prospects for FY 1988

Each December the Japanese cabinet drafts an economic outlook for the coming fiscal year that becomes part of the budget process. In broad terms the FY 1988 outlook projects a continuation of current trends (see Tables 2-4). The government expects inflation-adjusted growth to accelerate to 3.8 percent from FY 1987's 3.7 percent target, even though it is planning to limit the expansion in public-sector spending to 1.7 percent, well below the 3.5 percent pace for the current year when the supplemental budget amount is added. Moreover, the external sector will be a drag on growth for the third straight year.

In FY 1986 and FY 1987, the yen appreciated more than forecast in the outlook. In fiscal 1986 the assumption was Y204=\$1.00 and the actual rate was Y160=\$1.00. This made 4 percent real growth unobtainable; the government had to be content with 2.6 percent. In FY 1987, as noted above, a substantial supplemental budget triggered greater domestic demand to offset weaker than expected exports.

The same outcome is possible this year. Forecasts of the yen-dollar exchange rate vary widely. Some economists, taking heart from the dollar's direction in January and February, even expect the dollar to strengthen over the next few months. It is more likely, though, that it will have to decline further to reduce the U.S. trade deficit significantly. If the president elected in November is seen as credible in attacking this country's budget deficit, the dollar might drop; smaller budget deficits reduce the demand for foreign capital flows, which in turn slows the the number of foreign investors wanting to exchange their currency for dollars.

If the dollar does resume its decline, Japan will experience lower growth or will be forced to implement a more expansionary domestic policy. The government is again counting on private domestic demand to carry most of the load. Success, even in the absence of further upheavals in the currency markets, is far from guaranteed.

Table 2: Government's FY 1988 Economic Outlook

(percent change)

	<u>Actual</u>		<u>Estimated</u>		<u>Projected</u> <u>FY 1988</u>
	<u>FY 1984</u>	<u>FY 1985</u>	<u>FY 1986</u>	<u>FY 1987</u>	
Real Gross National Product	5.1%	4.4%	2.6%	3.7%	3.8%
Consumer Spending	2.6	2.8	3.6	3.6	3.8
Residential Construction	0.5	2.9	10.9	16.5	1.9
Private Capital Spending	11.5	13.2	4.5	7.1	9.8
Government Spending	0.8	-1.7	7.8	3.5	1.7

Source: Economic Planning Agency

Table 3: Nominal Gross National Product

(in trillions of yen)

	<u>Actual</u>		<u>Estimated</u>		<u>Projected</u> <u>FY 1988</u>
	<u>FY 1984</u>	<u>FY 1985</u>	<u>FY 1986</u>	<u>FY 1987</u>	
Gross National Product	Y303.0	Y321.2	Y334.7	Y348.4	Y365.2
Consumer Spending	178.1	186.5	193.1	201.2	211.5
Residential Construction	14.2	14.8	16.2	19.4	20.0
Private Capital Spending	47.1	52.8	53.8	56.4	62.0
Private Inventories	1.3	1.8	0.5	0.8	1.4
Government Spending	52.9	52.8	55.7	58.9	60.2
Net External Sector	9.4	12.5	15.4	11.8	10.3

Source: Economic Planning Agency

Table 4: Other Indicators

(percent change from previous year unless otherwise indicated)

	<u>Actual</u>		<u>Estimated</u>		<u>Projected</u> <u>FY 1988</u>
	<u>FY 1984</u>	<u>FY 1985</u>	<u>FY 1986</u>	<u>FY 1987</u>	
Industrial Production	9.9%	3.4%	-0.5%	6.6%	7.6%
Wholesale Prices	0.4	-3.3	-9.4	-1.7	0.3
Consumer Prices	2.2	1.9	0.0	0.7	1.3
Unemployment (in thousands)	1,590	1,580	1,710	1,700	1,650

Source: Economic Planning Agency

Private-sector forecasters agree with the government's upbeat outlook (see Table 5). They were generally far less optimistic about prospects for FY 1987 and hence even further off the mark than government economists. Their original average prediction of 2.4 percent real growth will fall short of the economy's actual performance by at least 1 percentage point; in fact all 25 private-sector forecasts summarized a year ago now appear to have been too pessimistic even though they all underestimated the appreciation of the yen. For FY 1988 they anticipate real growth of 3.6 percent and an average exchange rate of ¥129=\$1.00, close to its recent value. The Research Institute of the National Economy, the most optimistic -- and the most accurate -- forecaster of FY 1987 developments is equally upbeat about the coming fiscal year, predicting real growth of 4.3 percent.

A few respected individual economists have dramatically different views. Hisao Kanamori, head of the prestigious Japan Economic Research Center, estimates 5.5 percent real GNP growth based on the benefits of the appreciated yen and increasingly broad-based consumption growth. Johsen Takahashi, senior economist at the Mitsubishi Research Institute, is more pessimistic than his institute, seeing only 2 percent inflation-adjusted growth based on such demand-dampening developments as the appreciation of the yen to as high as ¥100=\$1.00.

Generally, the close bunching of government and private-sector opinions would seem to warrant confidence in the figures, but that would be a mistake. As shown in Table 5, relatively little change in oil prices or exchange rates is expected, in many cases probably reflecting a belief that the possibility of significant change upward or downward is equally likely. Put another way, there is a good chance that the economy's performance will either be much worse or much better than the figures in the table suggest. With that caveat in mind, the stage is set for real growth of around 3 percent, somewhat lower than the consensus.

External Demand - With Japan the largest exporter of goods to the United States, it would not be surprising if Americans thought the Japanese economy was dependent on the United States. It is true that this country is by far Japan's largest trading partner, taking about 37 percent of its exports in 1987, down slightly from 39 percent in 1986. While expanding net exports to the United States and elsewhere help Japanese growth, they have not always been necessary. From FY 1970 to FY 1987, Japan's economy grew every year except FY 1974, even though net exports declined six times, including FY 1986 and FY 1987.

U.S. demand for imports is important, of course. In its economic outlook published in December 1987, the Organization for Economic Cooperation and Development estimated the effect on Japan of a further 15 percent depreciation of the dollar against the yen and other currencies except the Canadian dollar. If the depreciation occurred at the start of the year, it would reduce Japanese economic growth by 0.2 to 0.3 percentage point depending on the actions of the world's central banks. In addition, Japan is affected by the rate of growth in the U.S. economy: a recession would decrease demand for Japanese exports and reduce its growth rate.

Table 5: Summary of Private Forecasts, FY 1988

(percent change in real terms unless otherwise indicated)

	<u>GNP</u>		<u>Current</u>	<u>Y/\$</u>	<u>Oil Prices</u>
	<u>Revised</u>	<u>Initial</u>	<u>Account</u>	<u>Exchange</u>	<u>(\$/barrel)</u>
	<u>FY 1987</u>	<u>FY 1988</u>	<u>Surplus*</u>	<u>Rate</u>	
<u>Banks</u>					
Taiyo Kobe Bank	3.8%	4.2%	\$75.0	¥130.5	\$18.7
Tokai Bank	3.5	4.0	60.0	130	18.0
Yasuda Trust	3.9	4.0	78.5	130	18.2
Fuji Bank	3.8	3.7	78.0	125	17.5
Industrial Bank of Japan	3.8	3.6	81.3	130	19.4
Chuo Trust	3.6	3.5	69.0	129.8	18.5
Mitsui Trust	3.1	3.5	68.2	130.2	18.5
Mitsubishi Trust	3.5	3.5	60.2	130	19.0
Hokkaido Takushoku Bank	3.6	3.5	74.4	128.5	19.5
Dai-Ichi Kangyo Bank	3.3	3.2	73.5	127	19.5
Bank of Tokyo	3.3	3.2	65.7	133	19.5
<u>Insurance Companies</u>					
Sumitomo Life	3.6	3.8	85.7	130.3	19.2
Asahi Mutual Life	3.6	3.7	79.1	129.0	19.5
Meiji Mutual Life	3.7	3.7	71.8	125	18.0
Nippon Life	3.4	3.4	81.6	125.0	19.1
<u>Research Organizations</u>					
Research Institute of the National Economy	4.0	4.3	77.3	128	17.5
Daiwa Securities					
Research Institute	3.6	4.0	66.1	126.8	16.5
Yamaichi Research Institute	3.7	3.8	68.8	133	17.0
Japan Economic Research Center	3.9	3.7	75.0	124.4	18.9
Okasan Economic Research Institute	3.9	3.7	77.0	130.0	19.0
Nomura Research Institute	3.9	3.6	75.1	123	17.0
Nikko Research Center	3.7	3.6	70.4	130.0	19.0
Cosmo Research Center	3.7	3.4	76.3	135.6	18.8
Kansai Economic Research Center	3.8	3.3	86.9	130.1	19.0
Mitsubishi Research Institute	3.6	3.2	84.5	123	18.7
Average Forecast	3.7	3.6	74.4	128.7	18.5

*In billions of dollars

A recession in the United States is a possibility. The leading economic indicators have declined for three months in a row, often a sign of approaching recession. But most economists are more optimistic, predicting inflation-adjusted growth in the 1 to 2 percent range for calendar 1988.

Growing earnings on overseas investments will be a factor boosting the current account surplus in dollar terms, but even with substantial growth beyond their \$16 billion level in calendar 1987, these returns will not be large enough to offset the growth in imports, leading to a decline in the overall current account (see Table 6). The composition of merchandise exports will change, with components for assembly in overseas plants becoming more important. In yen terms, exports will decline while expanding in dollars, the difference reflecting the yen's recent appreciation.

Table 6: Japan's Trade and Current Account Balances

	<u>Actual</u>		<u>Estimated</u>		<u>Projected</u>
	<u>FY 1984</u>	<u>FY 1985</u>	<u>FY 1986</u>	<u>FY 1987</u>	<u>FY 1988</u>
<u>Dollars (billions)</u>					
Current Account	\$37.0	\$55.0	\$94.1	\$82.0	\$72.0
Trade	45.6	61.6	101.6	92.0	81.0
<u>Yen (trillions)</u>					
Current Account	¥9.0	¥12.1	¥15.1	¥11.5	¥9.6
Trade	11.1	13.5	16.2	12.9	10.8
Exports	40.9	39.8	33.8	32.2	32.1
Imports	29.8	26.2	17.5	19.3	21.3

Source: Bank of Japan and Economic Planning Agency

Other forecasts of the current account surplus in FY 1988 differ from the government's assumption of a \$10 billion contraction to \$72 billion. The Bank of Tokyo, Ltd. sees a decline to \$66 billion, but Sanwa Bank, Ltd. expects the surplus to come in at \$77 billion. All forecasters agree that the FY 1988 dollar-denominated surplus will still be much larger than in any 12-month period prior to FY 1986. At the same time, a declining current account surplus will be paired with a drop in the net long-term capital outflow, reflecting in part investors' caution about dollar-denominated assets but also an increasing capital inflow as foreign investors return to Tokyo financial markets.

Domestic Private Demand - Spurred by low interest rates, housing has been a strong spot in the Japanese economy, rising by almost 23 percent in calendar 1987. In the third quarter, private residential construction contributed almost one-third of the growth of real domestic demand. Growth may already have peaked, though, and few observers expect much further contribution, primarily because the new units were a response to accumulated demand. Sanwa Bank, in a typical forecast, sees a small drop in housing starts but a 1 percent gain in the real value of residential construction.

Easily the biggest part of Japanese domestic demand is consumer spending. Even small changes in personal consumption, which accounts for over half of GNP, can be decisive in determining the direction of the economy. The government's outlook clearly depends on this sector to carry a lot of weight in FY 1988 since both government spending and housing are expected to register slow growth.

There are reasons to expect a lift from this sector. Low interest rates on consumer loans should be a spur, and consumers benefit at least a little from the appreciating yen, which has helped keep inflation low. As export-oriented firms put new emphasis on the domestic market, consumers benefit from lower prices and new, attractive products. Moreover, government pump-priming measures taken in FY 1987 are expected to increasingly spill over into consumption in FY 1988. In addition to the tax cuts of late FY 1987, taxes will be cut by ¥700 billion (\$5.6 billion) in FY 1988. With inflation expected to continue at moderate levels and wage increases this spring expected to exceed last year's 3.6 percent, Nomura Research International is forecasting that consumption in real terms will grow by 3.6 percent.

A striking characteristic of Japanese growth in FY 1987 has been the depletion of inventories (see JEI Report No. 5B, February 5, 1988), a reverse of the situation in the United States where stocks have been accumulating. As U.S. producers work down their inventories, growth is likely to suffer. In Japan, rebuilding inventories to levels corresponding to expected levels of economic activity will be a major factor pulling up domestic demand. Nomura, for example, expects private inventory investment to contribute 0.3 percentage point to its overall estimate of 3.6 percent real GNP growth in FY 1988.

The brightest part of domestic demand, however, is widely anticipated to be private plant and equipment investment. Expected profits are an important factor in predicting capital spending, and manufacturing profits, which slumped almost 30 percent in FY 1986, are expected to increase substantially in both FY 1987 and FY 1988 (see Table 7). At the same time, earnings in the nonmanufacturing sector are predicted to drop, mainly because of rate cuts by public utilities passing on the benefits of lower energy prices.

Table 7: Corporate Profit Outlook

(year-to-year percent change, unconsolidated pretax profits)

	<u>FY 1986</u> <u>(actual)</u>	<u>FY 1987</u> <u>(forecast)</u>	<u>FY 1988</u> <u>(forecast)</u>
Major Non-financial Firms (441 firms)	-7.4	+6.2	+13.5
Manufacturing Firms (323 firms)	-29.9	+51.4	n.a.
Nonmanufacturing Firms (118 firms)	+16.8	-23.2	n.a.

Source: Waco Research Institute of Economics

Nomura sees an 8.7 percent increase in real plant and equipment investment, but the Bank of Tokyo, which expects domestic capital spending to suffer as Japanese corporations invest abroad, puts the increase at 5.2 percent. A recent survey by the daily Nihon Keizai Shimbun showed that the polled 896 firms plan to increase investment by 5.8 percent, including a 13 percent jump by manufacturing firms.

Some Japanese analysts are worried that the predictions of increased consumer spending might turn out to be too optimistic while investment plans prove correct. If capital spending adds capacity, manufacturing firms might try to export the additional production if they cannot sell it at home, leading to new trade frictions.

Government Policies

The government was unable to get major tax reform in 1987, although some changes were made in the tax system (see JEI Reports No. 20A, May 22, 1987, and No. 30B, August 7, 1987). While Prime Minister Noboru Takeshita and others continue to talk about far-reaching tax reform, it may be postponed again. Even if some kind of measure is passed, it is likely to be revenue neutral and have little effect on the economy as a whole.

In 1987 the government took a larger role in stimulating domestic demand than it had originally intended, implementing measures that increased spending and reduced taxes. In the new fiscal year it plans to be less active, expanding real spending by only 1.7 percent. As a result, government spending will contribute only 0.3 percentage point to the forecast growth rate, far less than in the current and previous fiscal years. On the other hand, many economists assume that the government will have to revise its plans. Nomura, for example, is projecting a 4.6 percent increase in government spending in FY 1988, which means the government sector would contribute 0.6 percentage point to overall real growth.

In addition, the government will be worrying about the budget deficit, which it is eager to reduce, and inflation, which it hopes to avoid. Some government spending planned for January-March 1988 was put off until after April 1 in response to fears that prices of construction materials were rising. If the yen should resume its upward movement, the government could be forced to temporarily abandon its fight against inflation and red ink in favor of measures to keep the expansion going.

Monetary policy was particularly important for the Japanese government in calendar 1987. At the end of the year the money supply (M2 + CDs) stood 11.5 percent higher than in December 1986. For most of 1987 growth on a year-to-year basis was in double digits. The Bank of Japan is expected to gradually slow down the expansion but keep it above the real rate of growth of the economy for the foreseeable future.

Conclusion

Since early 1985 when the yen began its sustained rise against the dollar and many other currencies, the Japanese economy has been changing in dramatic ways. While the statistics sometimes appear contradictory, the broad

outlines are clear. Increasing domestic demand is more than offsetting a decline in real net exports to keep the economy growing. For the year that begins April 1, the best guess for inflation-adjusted GNP growth is around 3 percent. But given the fact that growth is occurring in the midst of a considerable transformation of the economy and in the context of hard-to-predict external forces, any predictions about the Japanese economy are far more uncertain than the close clustering of forecasts from different sources suggests.

Japan's high savings rate has been simultaneously financing a large budget deficit at home, part of the U.S. budget deficit, and capital spending by Japanese companies in Japan and abroad. An important question for the future is how rising consumption, which reduces savings, will be reconciled with new demands on those savings. A continuing large U.S. budget deficit, and the demand it generates for financing from Japan and elsewhere, would make the Japanese transition toward domestic consumption-led growth more difficult.

For further information, contact Douglas Ostrom.

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The views expressed in this report are those of the author and do not necessarily reflect those of the Japan Economic Institute.

Appendix: Japan's Real Gross National Product at Constant (1980) Prices

(in billions of yen, seasonally adjusted, quarterly totals and rates of growth at annual rates)

	FY 1985	FY 1986	October- December 1986	January- March 1987	April- June 1987	July- September 1987
Gross National Product	Y293,903.6 (4.4%)	Y301,679.7 (2.6%)	Y302,299.0 (2.8%)	Y306,780.1 (6.1%)	Y306,805.8 (0.0%)	Y313,046.7 (8.4%)
Personal Consumption Spending	163,315.8 (2.8%)	169,195.1 (3.6%)	168,584.8 (-2.3%)	171,935.2 (8.2%)	173,089.9 (2.7%)	174,678.2 (3.7%)
Private Residential Construction	14,095.9 (2.9%)	15,637.9 (10.9%)	16,263.4 (22.6%)	16,459.1 (4.9%)	16,950.2 (12.5%)	18,696.9 (48.0%)
Private Fixed Nonresidential Investment	53,920.4 (13.2%)	56,361.2 (4.5%)	56,543.9 (7.3%)	57,949.6 (10.3%)	58,973.3 (7.3%)	60,292.3 (9.3%)
Change in Business Inventories	2,036.0 (*)	515.2 (*)	885.7 (*)	143.9 (*)	906.7 (*)	1,046.3 (*)
Government Current Expenditures	27,158.2 (1.6%)	29,002.0 (6.8%)	31,983.9 (70.9%)	28,384.9 (-38.0%)	28,726.6 (4.9%)	28,631.7 (-1.3%)
Government Fixed Investment	20,796.1 (-6.3%)	22,162.2 (6.6%)	22,262.1 (3.6%)	22,417.9 (2.8%)	22,797.4 (6.9%)	23,545.4 (13.8%)
Change in Government Inventories	297.8 (*)	816.0 (*)	-1,891.6 (*)	226.2 (*)	-102.2 (*)	-9.2 (*)
Net External Sector	12,283.4 (20.9%)	7,990.1 (-35.0%)	7,666.9 (13.5%)	9,263.3 (113.1%)	5,463.9 (-87.9%)	6,165.1 (62.1%)
Exports of Goods and Services and Factor Income Received	54,664.2 (2.1%)	52,689.5 (-3.6%)	52,147.6 (-2.3%)	53,451.0 (10.4%)	52,466.1 (-7.2%)	55,958.2 (29.4%)
Imports of Goods and Services and Factor Income Paid	42,380.8 (-2.3%)	44,699.5 (5.5%)	44,480.7 (-4.8%)	44,187.7 (-2.6%)	47,002.2 (28.0%)	49,793.1 (26.0%)

*Cannot be calculated or meaningless.

Source: Economic Planning Agency

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JEI

R E P O R T

A Two-Part Report: A and B

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Trade Bill Could Depend On Primary Results

Legislators have finally started work again on HR 3, the omnibus trade bill. During the week of February 15, subconferees from the House Ways and Means and Senate Finance Committees met to review the proposals under their jurisdiction, but the sessions amounted to nothing more than a verbal "walk-through." Chairmen Dan Rostenkowski (D, Ill.) and Lloyd Bentsen (D, Tex.) said they will begin the formal voting process during the week of February 22 and have planned to send a bill to the House and Senate by the beginning of April.

Interestingly enough, the subconference is scheduled to consider the least controversial items first. Issues that involve fundamental differences of philosophy, such as unfair trade practices cases (Section 301 of the Trade Act of 1974), relief for industries that are hard-hit by imports (Section 201 of the Trade Act of 1974), special market access provisions, antidumping and

If this happens, Japanese banks will be ahead of the game. If they believe that they have to grow in California to defend their position against the expected onslaught from the New York banks, the recent mergers and reorganizations put them in a position to do so at reasonable cost. If they agree with observers that the competitive situation will eventually make it difficult for any bank to make money in California, they will have substantial banking organizations in place to sell to the very outsiders expected to create the feared chaos. In this scenario, they could make handsome short-term profits and get out before problems arise.

In an apparent effort to stop Japanese institutions from acquiring more banks in the state and to answer the criticism of New York banks, California may move up the date for the introduction of full interstate banking. Japanese and other banks that have positioned themselves to benefit from interstate banking will be able to do so sooner, shortening the payback period on their investment.

Douglas Ostrom

Rough Sailing For Japan's Shipping Companies

While many industries appear to be adjusting to the strong yen relatively comfortably, Japan's international ship operators have taken a direct hit. The sixth-largest company, Showa Line, Ltd., recently announced plans to discontinue liner service, even on its major run, the North American route. Elimination of this service, which accounts for 30 percent of the firm's revenues, will permit Showa to concentrate on more profitable aspects of the business. All six large Japanese ship operators are losing money. In fiscal year 1986, which ended March 31, 1987, Showa lost ¥14.3 billion (\$114.4 million at ¥125=\$1.00), while total losses for the six were ¥69 billion (\$552 million). At least two more companies are expected to drop out of the North American liner market, leaving three Japanese companies in operation.

Chronic worldwide overcapacity in the shipping industry has led to rough competition. Showa, for example, has been unprofitable since 1984. The appreciation of the yen that began in 1985 has made matters worse. With rates set in dollars, revenues in yen have declined as the dollar has depreciated. Costs, part of which are in yen, have been less affected. When Japanese and other ship operators succeeded in raising east-bound rates between 1982 and 1984, shipping companies re-deployed ships from other parts of the world to the North Pacific, driving rates and profits down in early 1985. The two leading Japanese shipping companies, Nippon Yusen Kaisha, Ltd., and Mitsui O.S.K. Lines, Ltd., are reported to be negotiating a joint operating agreement for the North Pacific route and may eventually establish a new company to serve the market.

But Japanese firms are not the only ones with problems; two U.S. companies entered the North Pacific business in response to relatively high profitability in 1985 and 1986 but were forced to retreat. One of them, United States Lines, Inc., is now bankrupt. The two largest remaining U.S. companies on the route, Sea-Land Corp. and American President Lines Ltd., are profitable although APL receives an operating subsidy.

Beside stiff competition from the 24 firms from 13 other nations operating North Pacific routes, the six Japanese companies face new problems with their customers. Japanese manufacturers argue that the strong yen has hurt their international competitiveness, and have tried to convince ship operators from Japan and elsewhere to keep rate increases to a minimum.

Already weak because of severe competition, the companies have to deal with the high yen without two options available to their manufacturing counterparts: passing through to their customers part of the currency appreciation and retreating to the domestic market. Unless the yen dramatically reverses course, the industry will continue to suffer. While exports and imports will be as vital as ever to the economy, they will increasingly move on foreign ships. This will be reflected in the transportation figures of the balance of payments (see Table).

Douglas Ostrom

Japan's Trade in Transportation Services

(in millions of dollars)

	Credits (Exports)	Debits (Imports)	Balance
1984	\$12,886	\$15,917	-\$3,031
1985	12,444	15,093	-2,649
1986	11,316	13,853	-2,537
1987*	12,890	19,297	-6,407

*Preliminary

Source: Bank of Japan

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The views expressed in this report are those of the authors and do not necessarily represent those of the Japan Economic Institute.

STATISTICAL SUPPLEMENT

Trade and Payments Data
(in millions of dollars unless otherwise indicated)

	1985	1986	January- December 1986	January- December 1987	October 1987	November 1987	December 1987
Japan's Balance of Payments							
Trade Balance	\$55,986	\$92,827	\$92,827	\$96,464*	\$7,769*	\$6,638*	\$10,061*
Exports (f.o.b.)	174,015	205,591	205,591	224,432*	20,097*	18,601*	22,796*
Imports (f.o.b.)	118,029	112,764	112,764	127,968*	12,328*	11,963*	12,735*
Current Account Balance	49,169	85,845	85,845	86,688*	6,546*	5,792*	9,437*
Long-Term Capital (net)	-64,542	-131,461	-131,461	-137,127*	-18,476*	-14,133*	-5,921*
Overall Balance	-12,318	-44,767	-44,767	-29,545	-14,570	-5,420	1,564
International Reserves (end of period)	26,510	42,239	42,239	81,479	73,050	78,044	81,479
Japan's Customs Clearance Trade							
Trade Balance	46,099	82,743	82,743	79,833*	6,816	4,746	8,601*
Exports (f.o.b.)	175,638	209,151	209,151	229,228*	20,666	18,939	23,327*
Cars	25,402	32,945	32,945	35,714*	3,154	2,930	3,250*
Steel	13,566	12,706	12,706	12,608*	1,092	1,038	1,427*
Imports (c.i.f.)	129,539	126,408	126,408	149,395*	13,851	14,193	14,726*
Crude Oil	34,599	19,481	19,481	20,657*	1,747	2,017	2,002*
Japan-U.S. Trade							
Trade Balance	39,485	51,401	51,401	52,138	4,988	4,209	4,910*
Exports (f.o.b.)	65,278	80,456	80,456	83,580	7,732	7,019	8,004*
Imports (c.i.f.)	25,793	29,054	29,054	31,442	2,744	2,810	3,094*
U.S.-Japan Trade							
Trade Balance (f.a.s./c.i.f.)	-49,749	-58,575	-58,575	-59,825	-5,864	-4,847	-4,792
Exports (f.a.s.)	22,631	26,882	26,882	28,249	2,392	2,638	3,001
Imports (c.i.f.)	72,380	85,457	85,457	88,074	8,257	7,485	7,793
Trade Balance (f.a.s./Customs)	-46,152	-55,030	-55,030	-56,326	-5,540	-4,541	-4,471
Exports (f.a.s.)	22,631	26,882	26,882	28,249	2,392	2,638	3,001
Industrial Supplies	8,680	8,752	8,752	10,156	801	973	1,148
Capital Goods	5,939	6,728	6,728	7,769	622	778	931
Food and Feed	5,001	5,043	5,043	5,555	563	478	394
Consumer Goods	1,416	1,690	1,690	2,551	231	197	233
Imports (Customs)	68,783	81,911	81,911	84,575	7,932	7,179	7,472
Automotive Products	24,980	32,849	32,849	33,695	3,129	2,867	2,884
Capital Goods	21,516	25,334	25,334	28,947	2,675	2,455	2,720
Consumer Goods	14,017	15,451	15,451	13,385	1,408	1,139	1,127
Industrial Supplies	7,035	6,949	6,949	7,281	617	598	629

*Preliminary

STATISTICAL SUPPLEMENT

Japanese Economic Indicators

(percentage change from year-earlier period unless otherwise indicated)

	1985	1986	January- December 1986	January- December 1987	October 1987	November 1987	December 1987
<u>Discount Rate (end of period)</u>	5.0%	3.0%	3.0%	2.5%	2.5%	2.5%	2.5%
<u>Outstanding Money Supply</u>	8.4%	8.7%	8.7%	10.4%	11.7%	12.4%	11.5%
<u>Industrial Production</u>	4.6%	-0.4%	-0.4%	4.0%	9.0%	10.5%	9.2%
<u>Manufacturing Operating Rate</u>	1.2%	-4.8%	-4.8%	1.2%	6.0%	7.9%	7.6%
<u>Number of Bankruptcies</u>	-9.7%	-7.1%	-7.1%	-27.6%	-35.2%	-32.7%	-32.5%
<u>Residential Construction Starts</u>	4.1%	10.4%	10.4%	22.7%	26.6%	25.2%	20.8%
<u>Job Openings to Applications (ratio)</u>	0.68	0.62	0.62	0.70	0.78	0.81	0.85
<u>Nominal Wages</u>	3.6%	3.5%	3.5%	2.7%	4.0%	3.0%	3.3%
<u>Labor Productivity</u>	4.2%	2.3%	2.0*	5.0*	n.a.	n.a.	n.a.
<u>Wholesale Prices</u>	-1.1%	-9.1%	-9.1%	-3.7%	0.1%	-0.7%	-1.1%
<u>Consumer Prices</u>	2.0%	0.6%	0.6%	0.1%	0.7%	0.7%	0.8%
<u>Yen-Based Export Prices</u>	-1.5%	-15.1%	-15.1%	-5.1%	-2.3%	-6.3%	-8.2%
<u>Yen-Based Import Prices</u>	-2.4%	-35.8%	-35.8%	-8.3%	8.0%	1.9%	-1.9%

*Through September of each year only.

For Japan's most recent GNP figures, see JEI Report No. 46B, December 11, 1987.

J A P A N · E C O N O M I C · I N S T I T U T E

JEI

R E P O R T

A Two-Part Report: A and B

NO. 9A

March 4, 1988

JAPAN AND THE MIDDLE EAST: ECONOMIC AND POLITICAL RELATIONS

Summary

Because Japan depends on the Middle East for almost 70 percent of its crude oil supplies, the security of the region is of critical importance to Tokyo. This report examines Japan's attempts to protect its economic and security concerns in the region and discusses the differences between its policies and those of the United States. It also analyzes the delicate balance that Tokyo has maintained between its relations with Arab countries and its desire to support U.S. foreign policy interests.

Introduction

Japan's historical and cultural relations with countries in the Middle East are weak. Although studies show some contacts dating from the 19th century, political ties between Japan and the Middle East have been tenuous. Most analysts, in fact, stress the newness of Tokyo's diplomatic initiatives in the region. Its role in the area has focused overwhelmingly on economic concerns -- especially oil. Japan depended very heavily on reasonably priced petroleum to build its postwar export economy; Miami University political scientist William Campbell even goes so far as to say that it is "clear that oil has made the Japanese miracle possible."¹ The singlemindedness with which Tokyo perceives its economic interests in the Middle East is shown even in its statements on cultural links between Japan and the region: "Many oil-producing countries in the Middle East are organized under a monarchy system and feel a sense of intimacy with the Japanese Imperial Household." (Emphasis added.)

¹Campbell, William R., "Japan and the Middle East." Japan's Foreign Relations. Edited by Robert Ozaki and Walter Arnold. Boulder: Westview Press, 1985.

But not even interest in the region's oil supplies prompted strong diplomatic measures in the immediate postwar period. Japanese refineries initially contracted with international oil companies for Middle Eastern oil deliveries. This system worked well in the 1950s and 1960s since it allowed industry to develop without Tokyo becoming embroiled in diplomatic and political problems.

Tokyo derived some lasting benefits from this hands-off policy. Since it had no colonial or military ties to the region, Middle Eastern countries harbored no resentment for past disagreements. As a result, Japan continues to be viewed as a formidable economic power, one that would provide a good model for development, but as a negligible military and secondary political influence in any given country.

From Tokyo's perspective this is just fine. Because it has been successful in maintaining strong diplomatic ties with many countries in the region, Tokyo is in the unusual position of being able to act as a go-between in regional disputes. By contrast, the past policies of the United States, the Soviet Union and several European countries preclude any opportunity for them to act as neutral intermediaries.

All good things must come to an end, however, including Tokyo's ability to maintain a healthy trade relationship with Arab oil producers while avoiding political involvement. After the 1973 Arab-Israeli war and the formation of the Organization of Petroleum Exporting Countries, Japan and other oil importers were faced with the threat of an Arab oil embargo if their foreign policy was not deemed "friendly" to the Arab cause. For the first time Tokyo was forced to evaluate its political goals and strategies in the Middle East. Its reluctance to do so is highlighted in the 1982 Diplomatic Bluebook, which noted that "... Middle Eastern countries have recently been placing greater expectations on Japan. As a result, Japan, whether it wished or not, has begun to attract attention from the Middle East countries not only in the field of economy but also in politics."

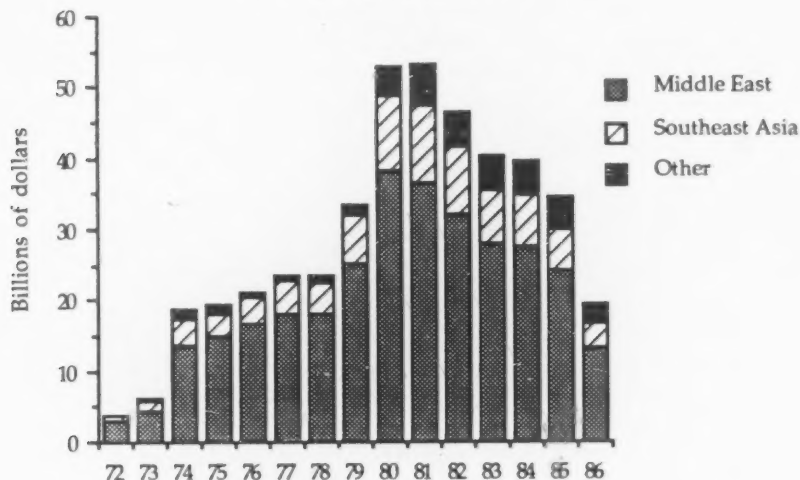
Tokyo responded to these "greater expectations" by focusing its attention much more closely on the region. Official visits to the Middle East increased. Tokyo sent a special envoy to several Arab countries in 1973 to establish friendly relations and to facilitate continued large petroleum sales to Japan. Moreover, in 1978 Takeo Fukuda became the first Japanese prime minister to visit the region, traveling to Iran, Qatar, Saudi Arabia and the United Arab Emirates -- all important suppliers of oil to Japanese companies.

The Importance of the Middle East to Japan

Oil accounts for roughly half of Japan's energy supplies. Consequently, it is difficult to overstate the importance of Middle Eastern oil to Japan's economy. Japan imported \$13.4 billion worth of crude oil from the region in 1986. Its suppliers included the United Arab Emirates, Saudi Arabia, Oman, Iran, Qatar, Iraq and Kuwait (in descending order of importance). These purchases accounted for approximately 69 percent of total imports of crude oil,

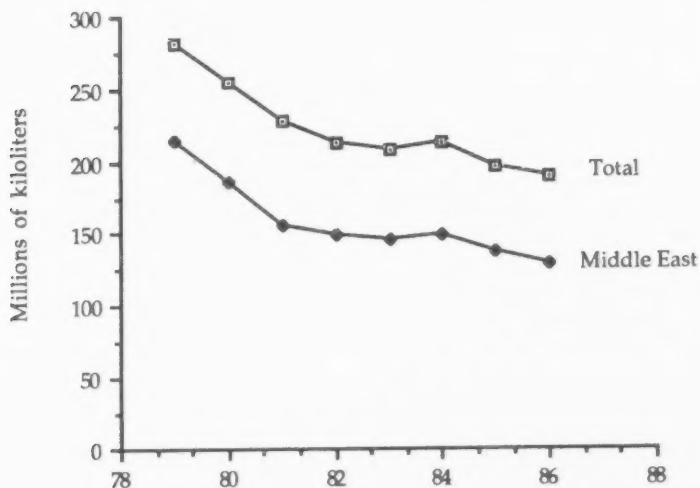
down from 1978 when the figure was over 78 percent. Still, the preeminence of the region as a supplier of energy resources to Japan is self-evident (see Figure 1).

**Figure 1: Japan's Imports of Crude Oil
By Region, 1972-86**



Since the oil crises of the 1970s, Japan has been attempting to diversify its energy resources and its reliance on oil has decreased steadily during this decade. Japan imported 189 million kiloliters of oil in 1986 as opposed to 281 million kiloliters in 1979 (see Figure 2).

Figure 2: Japan's Oil Imports, 1979-86



But the Middle East is of great importance to Japan in another way as well. Security concerns are receiving increasing attention as tensions mount in the Persian Gulf and between Israel and the Arab countries. Not only does Tokyo worry that instability in oil-producing countries could disrupt petroleum production, but it also must contend with possible shipping difficulties. The vast majority of Japan's Middle Eastern oil supplies must flow through the Persian Gulf and the Strait of Hormuz.

Because of its dependence on the region for petroleum, Japan is more vulnerable to the economic consequences of Persian Gulf tensions than countries that have other sources of supply. Fears of Soviet control of the Gulf or increased violence in the region mean that Japan has a vital stake in contributing to stability there and is willing to work for regional peace through non-military means.

The Arab-Israeli Conflict

In 1973 when OPEC threatened to cut off oil supplies to those countries that were unfriendly to the Arab cause, Tokyo found itself in an immediate dilemma. On one hand, it needed to secure deliveries of oil to protect the very foundation of its economy. On the other hand, Japan was sensitive to the United States' firm friendship with Israel. Tokyo's position was all but a no-win situation.

The government finally decided to tread a very narrow line between the two positions; it did embrace a pro-Arab policy but refused to sever diplomatic ties with Israel. Tokyo issued a statement in November 1973 that supported self-determination for the Palestinians and called for Israel's withdrawal from the territories it had occupied in the 1967 war. Its pro-Arab stance was perhaps most evident in the concluding sentence of the statement: "The government of Japan will continue to observe the situation in the Middle East with grave concern and, depending on future developments, may have to reconsider its policy toward Israel."

By all appearances the strategy worked. Arab suppliers accorded Japan "friendly nation" status and allowed Japanese firms to continue purchasing oil. With the advantage of hindsight, however, several analysts have questioned whether Japan's policy was as successful as it originally appeared. For example, although petroleum was available to Japan, it was at a premium. Moreover, its position did not appear to give Japan much more political influence with the Arab states.

Tokyo has also been criticized for formulating its policy solely on economic grounds. As a growing economic and diplomatic power, say critics, Japan should have focused on a combination of economic, political and diplomatic goals rather than on energy concerns. Complaints continue even today about the private sector's position on the Arab-Israeli question. Press reports surface in the United States from time to time charging that Japanese firms are complying with Arab demands that its trading partners boycott the Israeli market.

Tokyo has fought back with a message of its own: U.S. policy in the Middle East is too one-sided to be effective. The government argues that Washington does not pay enough attention to the issue of Palestinian rights. This is not to say, however, that Tokyo has actively attempted to persuade the

United States to change its policy. Rather, it would like to maintain a sort of balance between Arab and U.S. interests -- minimizing tensions rather than pushing for major changes in U.S.-Arab relations.

Washington would like to see Japan maintain an even lower profile on the Arab-Israeli question, but again, this poses a dilemma for Japan. As one official argues in Michael Yoshitsu's 1984 book, Caught in the Middle East:

"The U.S. has [consistently] told us not to do or say anything with regard to Mideast peace, arguing that [such statements or actions] would put it in a difficult position. Certainly, we feel that the role that Japan can play is quite limited and that America . . . not Israel . . . holds the key to Mideast peace. We would of course be happy to leave the problem if, apart from a few minor differences, we judged U.S. policy to be correct. But we feel that U.S. policy is incorrect. . . . And so we are at a loss when told to do nothing about a region that is crucial for Japan."²

Japanese officials also believe that the United States' approach in the region is too confrontational. They worry that Washington overemphasizes military responses to tensions -- a risky strategy, they believe, especially in view of the debacles in Iran and Lebanon. Moreover, officials have argued that Washington focuses too much on Israel's concerns, thereby leaving little room for flexibility in responding to regional disputes.

What, then, is Japan's position on the Middle East peace process? Tokyo begins by avowing its support for United Nations Security Council Resolution 242, which supports the rights of all Middle Eastern countries to exist in peace, calls for Israel's withdrawal from occupied territories and a "just settlement of the refugee problem." In fact, the government takes credit for helping to "coordinate international opinion" with regard to the resolution since it was adopted when Japan chaired the Security Council.

In addition, Tokyo supports "the legitimate rights of the Palestinian people in accordance with the U.N. charter," and has accepted the Palestine Liberation Organization as a spokesman for the Palestinians. Officials stress, though, that they do not recognize the PLO as the Palestinians' sole representative. In 1977 the PLO was allowed to establish an office in Tokyo. The office has not been given full diplomatic status, however, since officials feared that such a move would imply recognition of the PLO as the official spokesman for the Palestinians. Similarly, PLO leader Yassir Arafat was able to visit Tokyo in 1981. Although the visit was unofficial (having been sponsored by the Japan-Palestine Friendship Commission), Mr. Arafat met unofficially with Prime Minister Zenko Suzuki and Foreign Minister Sunao Sonoda. Tokyo has used its ties with the PLO both to highlight its support for Palestinian rights and to urge PLO leaders to formally recognize Israel's right to exist. Without the latter concession, Japanese officials say, it will be impossible for both sides to exist in peace as set forth in Resolution 242.

²Yoshitsu, Michael M., Caught in the Middle East. Toronto: Lexington Books, 1984.

The Iran-Iraq War

During the 1979 Iran hostage crisis, Japan again felt it necessary to stake out a different strategy than Washington's. Iran was a major supplier of oil to Japan as well as host to a multibillion-dollar Japanese petrochemical venture. Initially, Tokyo declined to take a position on the issue, saying that the conflict was a problem between two of its friends -- apparently hoping that the situation would resolve itself relatively quickly.

But pressures from Washington made this position untenable. U.S. officials reacted furiously to reports that Japanese companies had purchased Iranian oil that U.S. firms were boycotting, and at nearly double the posted price. When the severity of the crisis became apparent, Tokyo decided to reconsider its position and joined the European Community in implementing a series of economic measures against Iran that were to last for over a year.

When the crisis was finally resolved, Tokyo wasted no time in removing the measures and taking steps to establish friendly relations with the new Iranian government. The first test of these fragile ties was an Iranian request that Japan continue work on the Iran-Japan Petrochemical Co., a joint venture between Iran and a group of over 100 Japanese companies and banks led by Mitsui & Co., Ltd. Because Tokyo felt that a refusal would reflect badly on its reliability, the project continued.

Even when the Iran-Iraq war broke out in late 1980, Tokyo felt it would be an unwise diplomatic move if Japanese investors pulled out of the venture. As a result it persuaded a reluctant Mitsui to continue. The results have been unfortunate. Iraqi forces have bombed the installation repeatedly and have threatened to do so again if Mitsui undertakes any repairs. At present, work is stalled. Mitsui has demanded some payment for its work on the project to date, but Tehran insists that the project be resumed first.

Although the petrochemical plant is the most tangible evidence of Japan's stake in the Iran-Iraq war, it is by no means the only factor -- nor even the most important. Any tension in the Persian Gulf poses a threat to the safe transport of Japanese oil purchases. From Tokyo's perspective, Soviet control of the Gulf would be disastrous. Another factor that is not lost on Japanese officials concerns East Asian security. As some observers have pointed out, U.S. preoccupation with the Middle East means less attention to the Pacific Basin. Similarly, forces and supplies committed to that region are unavailable for use in protecting East Asia. While this concern may not pose as dramatic a threat as does the Gulf war and the threat of Soviet influence in the Middle East, it nonetheless has implications for Japanese security concerns.

Consequently, Tokyo has undertaken a series of measures to promote peace between Iran and Iraq. Officials believe that Japan is singularly well-equipped for this role since Tokyo has maintained relatively good relations with both Tehran and Baghdad. In 1983 Foreign Minister Shintaro Abe visited both countries to advocate peace and pledge Japan's help in postwar economic reconstruction. The next year Tokyo hosted visits by the Iranian and Iraqi foreign ministers. Separate contacts such as these have continued to the present.

Tokyo is extremely conservative in characterizing its role in the peace process, saying that its "diplomatic efforts are not intended as mediation or

arbitration but are rather directed toward preventing escalation and creating a climate conducive to an early settlement." In this regard, observers have called Japan a "message carrier" rather than a mediator. Japanese officials also stress the part that the United Nations is playing in the peace efforts. They are especially hopeful about UN Resolution 598, which calls for a cease-fire between the two countries.

It is primarily because diplomatic efforts are ongoing -- both by the Japanese government and in the United Nations -- that Tokyo declined in October 1987 to join a U.S. trade embargo against Iran in response to Tehran's support of terrorism and acts of military aggression against non-belligerent vessels in the Persian Gulf. Japan's Vice Foreign Minister Ryohei Murata explained Tokyo's position by saying that "Japan understands the circumstances that led the United States to impose the economic sanctions. However, Japan finds it difficult to take similar measures." Officials go on to argue that sanctions are premature as long as there is a continuing effort to find a peaceful solution to the war. They also point out that although no noticeable policy change has occurred in Iran, Japanese arguments have been received as coming in a "spirit of friendliness."

Tokyo reportedly did agree, however, to urge the Japanese business community to hold down purchases of Iranian oil. In 1986 Japan's imports from Iran, which consist almost exclusively of crude oil, came to \$1.4 billion. This represented about 7 percent of Japan's oil imports (in volume terms) and roughly 20 percent of Iran's total exports. The Foreign Ministry stresses that Japan is less dependent on Iranian oil than American policymakers believe and that diplomatic rather than economic considerations prompted its decision not to participate in the embargo.

When the U.S. embargo was announced, Japan had already decided that it would provide financial assistance to support free navigation in the Persian Gulf. Its four-point plan includes installation of a British-made precision navigation system; a \$10 million contribution to UN peace efforts; additional economic aid for the region; and increased funds for American military bases in Japan.

The initiative has given Tokyo some breathing space by satisfying U.S. demands without endangering Japan's relationship with Iran. Former Defense Secretary Caspar Weinberger called the initiative "a fine first step toward a meaningful Japanese contribution." Tehran, for its part, accepted it as "non-hostile" -- although two Japanese oil tankers were hit by Iranian fire a few days after the announcement of the plan. Nonetheless, Washington has made little secret of its desire to see Tokyo contribute even more to stability in the Gulf, and it is not unlikely that it will make more demands on Japan in the future. The Reagan administration feels it has this right since Japan is a major beneficiary of the American commitment to protect reflagged Kuwaiti tankers.

Trade and Investment

If Japan's political involvement in the Middle East is on the rise, the same cannot be said for trade. Exports to oil-producing countries in the region have dropped steadily during the past several years, due in large part to the sharp decline in oil prices. As the foreign reserves of Middle Eastern

countries continue to contract, so does the market for Japanese goods. Furthermore, violence in the region has persuaded Japanese businesses to look elsewhere for sales -- for example, the United States (see Table).

Japan's Exports to Middle East Oil-Exporting Countries
and the United States, 1982-86

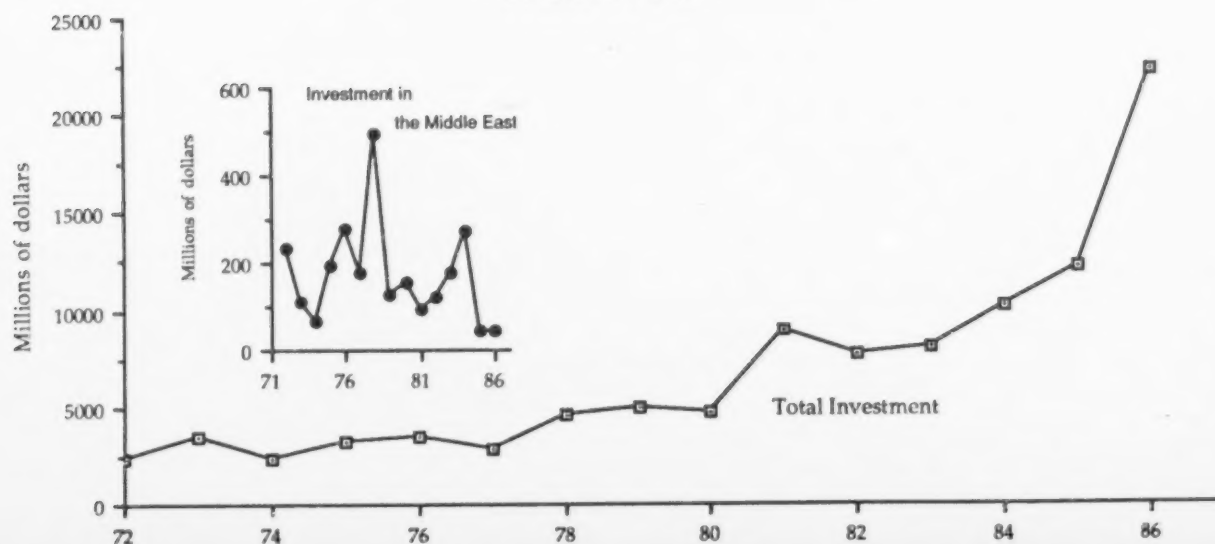
(in millions of dollars, f.o.b. value basis)

<u>Country</u>	<u>1982</u>	<u>1983</u>	<u>1984</u>	<u>1985</u>	<u>1986</u>
Iran	\$934	\$2,820	\$1,692	\$1,348	\$1,144
Iraq	2,755	631	806	1,306	1,211
Kuwait	1,790	1,763	1,432	1,536	1,219
Saudi Arabia	6,621	6,687	5,634	3,890	2,762
United Arab Emirates	1,493	1,357	1,126	1,164	1,032
Total	13,593	13,258	10,690	9,244	7,368
Percent of total exports	9.8%	9.0%	6.3%	5.3%	3.5%
United States	36,330	42,829	59,937	65,278	80,462
Percent of total exports	26.2%	29.1%	35.2%	37.2%	38.5%

Source: Japan Tariff Association

Similarly, direct investment in the region, not extensive to begin with, has contracted, falling from \$273 million in FY 1984 to only \$44 million in FY 1986 -- an 84 percent drop (see Figure 3). This was only 0.2 percent of Japan's total foreign direct investment in FY 1986, down from levels of 10 percent in FY 1972 and almost 11 percent in FY 1978. As long as the investment climate remains unstable, there is unlikely to be a resurgence of Japanese ventures in the region. The plight of the Iran-Japan Petrochemical Co. looms too large in the minds of Japanese investors.

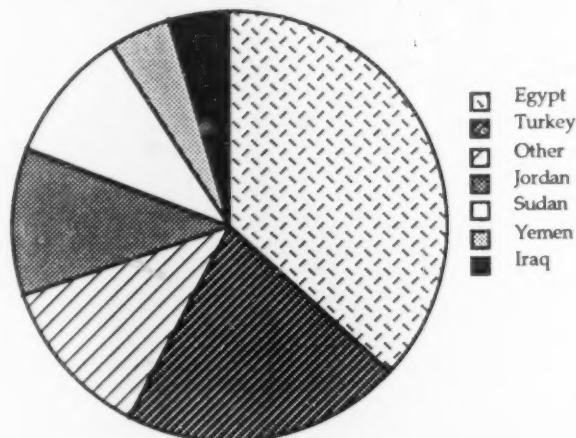
Figure 3: Japan's Foreign Direct Investment
FY 1972 - FY 1986



Economic Cooperation

Tokyo has embraced foreign aid as one of the primary means that it can use to contribute to stability in the Middle East. Working on the premise that political stability is impossible without economic security, Japan has pumped approximately 9 to 10 percent of its annual official development assistance disbursements into the region. It has focused on key moderate countries such as Egypt, which received \$126 million in 1986, making it the tenth-largest recipient of Japan's ODA. Tokyo also gives aid to countries that border unstable areas. For example, Pakistan received \$152 million in 1986 -- making it the eighth-largest recipient -- largely because of its precarious border with Soviet-occupied Afghanistan. In total the Middle East received \$340 million from Japan in 1986 (see Figure 4).

Figure 4: Major Recipients of Japan's Aid
to the Middle East, 1986



While Japan's aid does not come close to the amount spent by the United States, it serves a slightly different purpose. Tokyo will not provide military assistance of any kind; it will, however, increase economic assistance to countries that are important to the Western alliance. Consequently, Jordan and Turkey receive healthy amounts of aid. Japan is also willing to use economic assistance to preserve friendly relations with important oil suppliers; Saudi Arabia, for example, received \$13.5 million in 1986. It tries as well to satisfy both Western strategic concerns and Middle Eastern development requests by disbursing aid for specific situations -- such as disaster relief funds for Lebanon.

In this regard, differences between the policies of the United States and Japan regarding the Middle East may be somewhat overstated. The general strategies of Tokyo and Washington are the same, and in fact, Japan uses its economic assistance to support U.S. goals in the region. Furthermore, Tokyo is extremely open to U.S. suggestions about possible aid recipients. Certainly it is true that the Middle East represents the first real challenge by Japan to

some aspects of U.S. foreign policy leadership. Nonetheless, the similarities of their policies outweigh the differences. Both countries want to limit Soviet influence in the region and both hope to see the establishment of a lasting peace. In sum, Japan remains willing to let Washington take the lead in shaping the broad outlines of Middle East policy.

Tokyo's future aid policies regarding the Middle East are rather uncertain at present. Although it has given a great deal of thought to regional aid policies in the past few years and has outlined specific strategies for developing countries in Asia, Latin America and Africa, it still appears to lack a coherent aid philosophy for the Middle East. Moreover, in recent years proportionally more aid has gone to sub-Saharan African countries than to those in the Middle East or Latin America.

Part of the reason for this is that high per-capita incomes in the latter two regions pose eligibility obstacles under the Organization for Economic Cooperation and Development's aid guidelines. Another reason is that Tokyo believes that ODA is most appropriate for the poorest LDCs, such as those in Africa. It has been attempting to devise other ways to respond to the needs of middle-income countries, though, and announced in early 1987 that it would recycle \$20 billion of its current account surplus to debtor countries in Latin America and Asia. Thus far it has not crafted a specific response for the Middle East.

Nonetheless, because of the region's oil and strategic situation, Tokyo is certain to continue pumping economic assistance into the Middle East. And the criteria for the recipients is also likely to remain the same: ODA will go primarily to strategically important countries and to countries that are important to Japan's economic interests.

Conclusion

It is no understatement to conclude that the Middle East is absolutely vital to Japan's economic and political well-being. In economic terms Japan's dependence may decline as electric power companies look to new sources of energy and manufacturers seek out new export markets. But as long as Japan depends on Middle Eastern producers for the majority of its oil supplies, security concerns about the region will not abate. Even if Japan does diversify its energy supplies so that it can survive without Middle Eastern oil, both the threat of Soviet control as well as Tokyo's awareness of its responsibilities as a member of the Western alliance will insure that Japan continues to watch the Middle East with concern.

For further information, contact Eileen M. Doherty.

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The views expressed in this report are those of the author and do not necessarily represent those of the Japan Economic Institute.

JEI

R E P O R T

A Two-Part Report: A and B

NO. 9B
March 4, 1988

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Consumption Shows Uneven Pattern

While the aggregate indicators of the Japanese economy continue to move up, some sectors of the economy are not doing nearly as well. The just-released annual family income and expenditure survey shows consumption spending per household in 1987 rose only 1.9 percent in inflation-adjusted terms, with some groups up even less. The average household spent Y280,944 a month or \$2,248 at Y125=\$1.00. Expenditures by white-collar workers increased by just 1 percent in real terms to an average Y295,915 (\$2,367) a month, a particularly small increase considering a gain in disposable income of 2.3 percent and an increase in financial assets of 9.6 percent.

The Bilateral Trade Account: Still Waiting For Improvement

The U.S.-Japan trade results continue to defy the conventional wisdom. For two years economists and policymakers on both sides of the Pacific have been saying that the realignment of the dollar-yen exchange rate was moving exports and imports in the right directions and that the yawning bilateral trade gap would soon begin to narrow. Private-sector and government analysts, though, were hard-pressed to find signs of a turnaround in the 1986 figures since the deficit came in at \$58.6 billion (imports valued c.i.f.), \$8.8 billion more than 1985's total. The 1987 numbers were even more perplexing. Not only did the shortfall between imports and exports widen to \$59.8 billion despite the 50 percent depreciation of the dollar against the yen over the preceding 36 months, but there was just slim evidence that the quarterly deficit had bottomed out.

Although burned twice before, economists and policymakers here and in Japan are convinced that reality will catch up with the conventional wisdom this year. Their straightforward reasoning starts with the fact that U.S. exports to Japan turned in a much stronger performance in 1987 than the overall rise of 5.1 percent to \$28.3 billion indicated. Sales were actually up by 18 percent for the year, capped by a 22 percent gain in the October-December quarter, but this result was obscured because the 1986 export total was inflated by a \$3.1 billion transshipment of foreign bullion through the United States to Japan. Moreover, the competitive advantages of the weaker dollar and the healthy growth of Japanese domestic demand in 1987's second half produced a broad-based export expansion, one that extended from nearly all types of capital goods and consumer durables and nondurables to most major industrial and agricultural inputs, the laggards in 1986. With the dollar-yen exchange rate expected to remain under pressure and all signs pointing to continued economic expansion in Japan, analysts are confident that exports will post another big gain in 1988.

Predicting the behavior of imports this year is harder because there are a number of question marks -- how much more of the yen's appreciation Japanese exporters pass through, how fast U.S. demand responds to these and earlier price hikes, and how the American economy performs in general. Taken at face value, though, the 1987 import results suggest that purchases have peaked. The aggregate figure was up just 3.1 percent to \$88.1 billion on a c.i.f. basis, a far cry from 1986's 18.1 percent jump. Perhaps more important, computer equipment, specialized industrial machinery and automotive parts were among the few big import groups registering double-digit increases. Missing from the list were cars (up a slight 1.2 percent on a 7.7 percent shipment drop), trucks (down 13.2 percent in value and 20.8 percent in volume) and video cassette recorders. Any additions to this list, which already included steel, will insure a significant decline in the 1988 U.S.-Japan trade deficit.

Susan MacKnight

Notes

Construction Market Investigation - The Trade Policy Review Group recommended February 25 that the Reagan administration initiate an investigation

U.S. Exports to Japan

(in millions of dollars, f.a.s. value basis)

	January- December 1986	January- December 1987	Percent Change
<u>Total Exports</u>	<u>\$26,881.6</u>	<u>\$28,248.6</u>	<u>5.1%</u>
<u>Industrial Supplies</u>	<u>8,751.5</u>	<u>10,155.7</u>	<u>16.0</u>
Bituminous Coal	554.7	484.5	-12.7
Petroleum Products	567.7	661.3	16.5
Natural Gas	187.0	144.3	-22.8
Logs and Lumber	1,097.4	1,573.4	43.4
Paper Base Stocks	563.8	747.8	32.6
Paper and Paper Products	354.0	398.8	12.7
Organic Chemicals	731.8	870.4	18.9
Inorganic Chemicals	883.9	831.5	-5.9
Plastics and Synthetic Resin Compounds	322.0	403.9	25.4
Manufactured Fertilizers and Insecticides	246.1	297.7	21.0
Steel Scrap	170.0	123.1	-27.6
Nonferrous Ores and Scrap	491.8	553.9	12.6
Nonferrous Metals	205.8	394.3	91.6
Textiles	121.7	159.3	30.9
Raw Cotton	238.6	413.7	73.4
Hides and Skins	331.4	369.6	11.5
Leaf Tobacco	227.1	300.8	32.5
<u>Capital Goods</u>	<u>6,727.5</u>	<u>7,769.0</u>	<u>15.5</u>
Nonelectric Machinery	3,561.7	4,231.1	18.8
Data Processing Equipment	1,400.6	1,777.1	26.9
Measuring, Testing and Control Instruments	477.2	568.7	19.2
Laboratory Testing and Control Instruments	103.9	131.1	26.2
Scientific, Professional and Medical Equipment	337.0	433.6	28.7
Power Generating Equipment	77.1	108.6	40.9
Metalworking Equipment	143.0	126.4	-11.6
Service Industry Equipment	143.7	196.1	36.5
Electric Machinery	977.5	1,218.6	24.7
Generators and Transformers	73.7	68.3	-7.3
Broadcast and Communications Equipment	402.8	574.8	42.7
Telephonic and Other Electric Equipment	500.9	575.5	14.9
Transportation Equipment	2,188.3	2,319.1	6.0
Civilian Aircraft	1,161.3	1,094.9	-5.7
Civilian Aircraft Engines and Parts	659.6	753.6	14.3
Automotive Parts	235.0	274.4	16.8
<u>Food and Feed</u>	<u>5,042.8</u>	<u>5,555.1</u>	<u>10.2</u>
Corn	878.0	1,036.0	18.0
Sorghum	178.0	181.8	2.1
Soybeans	838.8	785.7	-6.3
Wheat	424.3	352.3	-17.0

Fruits and Vegetables	584.0	664.5	13.8
Meat and Meat Products	760.9	898.3	18.1
Fish and Fish Products	864.2	1,058.8	22.5
<u>Consumer Goods</u>	<u>1,689.9</u>	<u>2,550.8</u>	<u>50.9</u>
Pharmaceuticals	647.4	699.0	8.0
Toys and Sporting Goods	98.0	180.3	84.0
Cigarettes	128.0	491.9	284.3

U.S. Imports from Japan

(in millions of dollars, Customs value basis)

	<u>January- December 1986</u>	<u>January- December 1987</u>	<u>Percent Change</u>
<u>Total Imports</u>	<u>\$81,911.1</u>	<u>\$84,575.0</u>	<u>3.3%</u>
<u>Automotive Products</u>	<u>32,849.1</u>	<u>33,694.9</u>	<u>2.6</u>
Cars	21,060.7	21,304.7	1.2
Trucks	5,713.4	4,961.1	-13.2
Automotive Parts	6,065.6	7,427.2	22.4
<u>Capital Goods</u>	<u>25,333.9</u>	<u>28,946.8</u>	<u>14.3</u>
Nonelectric Machinery	17,230.9	19,626.2	13.9
Business Machines	7,901.9	9,709.3	22.9
Metalworking Machinery	1,475.3	1,391.4	-5.7
Specialized Industrial Machinery	1,598.0	1,870.4	17.0
Scientific, Professional and Medical Equipment	835.2	879.7	5.3
Electric Machinery	7,532.5	8,517.7	13.1
Transportation Equipment	570.5	802.9	40.7
<u>Consumer Goods</u>	<u>15,451.1</u>	<u>13,384.5</u>	<u>-13.4</u>
Video and Audio Recorders and Players and Stereo Equipment	5,881.1	4,068.8	-30.8
Television Sets	869.0	508.8	-41.4
Radio Receivers	272.9	271.9	-0.4
Tableware and Glassware	453.8	434.2	-4.3
Metal Cookware and Cutlery	473.0	422.1	-10.8
Photographic and Optical Goods	1,164.8	1,198.5	2.9
Clocks and Watches	477.2	526.1	10.2
Toys and Sporting Goods	523.1	749.4	43.3
Motorcycles and Parts	853.3	553.2	-35.2
Clothing	464.0	379.4	-18.2
<u>Intermediate Goods</u>	<u>6,948.7</u>	<u>7,281.0</u>	<u>4.8</u>
Steel Mill Products	2,231.5	2,214.7	-0.8
Nonferrous Metals	504.6	450.6	-10.7
Organic Chemicals	732.2	846.9	15.7
Inorganic Chemicals	118.9	166.0	39.6
Textiles	855.4	755.5	-11.7

into Japan's construction bidding practices under Section 301 of the 1974 Trade Act. The subcabinet-level advisory body first reached this consensus in early December 1987, but postponed the actual vote until now to give Prime Minister Noboru Takeshita time to develop a compromise. The group had hoped that the prime minister would bring a new offer to Washington and that subsequent talks would reveal some chance of a breakthrough. With only modest progress made in a mid-February series of discussions (see JEI Report No. 8B, February 26, 1988), the group's move puts more pressure on Tokyo. The cabinet-level Economic Policy Council will now study the recommendation and decide whether to forward it to the president for action.

Salmon Fishing Rights - Tokyo and Washington are working to overturn a court judgment that threatens a bilateral salmon fishing pact. In a case filed by American environmentalists, the U.S. Court of Appeals upheld a lower court ruling banning Japanese salmon fishing within the 200-mile U.S. economic zone on the grounds that it violated laws aimed at preventing the unnecessary killing of dolphins. Washington agreed with Tokyo that the ruling contradicts the salmon fishing agreement's provisions and will appeal the decision. It is not likely, however, that the Marine Mammal Protection Act will be amended as Tokyo has requested.

Tokyo also faces a challenge to traditional salmon fishing from the Soviet Union. Soviet negotiators have proposed a "new type of salmon fishing" to replace current Japanese offshore fishing methods as part of this year's salmon fishing agreement. It is not clear what the new method is, but it could be a prod to force Japan to establish joint ventures with Soviet fishermen and stop all independent salmon fishing in Soviet waters. Last year Tokyo paid Y3.7 billion (\$29.6 million at Y125=\$1.00) in fees for the right to take 24,500 metric tons of salmon. The Soviets claim that the salmon runs are still declining despite reduced catches and increased repopulation programs. Tokyo expects Moscow to demand further quota cuts and higher fees, but asserts that salmon populations are climbing and will push for the status quo.

Correction

In JEI Report No. 8A, February 26, 1988, the 1986 data in Tables 2, 3, 4, and 6 labeled estimated is in fact actual data.

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The views expressed in this report are those of the authors and do not necessarily represent those of the Japan Economic Institute.

J A P A N · E C O N O M I C · I N S T I T U T E

JEI

R E P O R T

A Two-Part Report: A and B

NO. 10A

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THE APPRECIATING YEN AND JAPANESE EXPORT PRICING

Summary

The dollar has lost 50 percent of its value against the yen over the past 36 months. Yet Japanese exporters have only marked up their U.S. prices by roughly half this amount. To many American competitors this is another example of corporate Japan flaunting international trade rules. But the failure of Japanese manufacturers to increase export prices in line with the dollar's decline is not prima facie evidence of dumping -- selling products here for less than at home -- since this is the wrong comparison. The correct test is the relationship between manufacturers' export prices and their prices in Japan. Exporters in a range of industries argue that products for sale in the United States were priced above those in the domestic market when the dollar started to depreciate in February 1985 because they had not trimmed export prices while the American currency was rising in value during the first half of the 1980s. At the same time, however, the fact that Japan's manufacturing sector has been able to offset a big part of the dollar-yen realignment through extensive cost-cutting and enormous savings on imported inputs is not incontrovertible proof that Japanese-made products are being sold in this country at fair value.

The Dollar's Drop: Theory and Reality

If the strong dollar was responsible for much of the runaway growth of the U.S. trade deficit during the first half of the 1980s, then a weaker dollar should narrow the yawning gap between imports and exports. That in oversimplified terms was the reasoning when the United States, Japan, West Germany,

England and France agreed in September 1985 to launch a coordinated campaign to drive down the value of the American currency. Theory and reality, however, have not yet meshed. Since peaking in February 1985, the dollar has declined by roughly 50 percent against the currencies of the world's 10 other major industrial nations and is now within striking range of its July 1980 low. But the U.S. trade deficit, which widened by nearly \$100 billion between 1981 and 1985 to \$133.7 billion, has continued to expand, hitting \$156.2 billion in 1986 and \$171.2 billion last year.

True, U.S. exports are moving in the right direction. Foreign sales finally topped their 1981 all-time high in 1987, increasing 11.5 percent to \$252.9 billion. More important, the volume of exports, which had rebounded 3.3 percent in 1986, jumped 12.8 percent. The major problem is on the other side of the trade ledger. The U.S. import bill is still climbing -- and not just because the weaker dollar inflates import prices; the volume of products bought from abroad has also continued to rise. In fact, 1987's import gain of 10.7 percent to \$424.1 billion was more the result of bigger volume (up 7.3 percent) than higher prices, while the 8.7 percent expansion in 1986 purchases was entirely due to a 10.5 percent volume increase.

Why are the import numbers behaving so perversely? The reasons are starting to have a familiar ring. Although the dollar has dropped against the yen and the currencies of West Germany, England, France and Italy over the last 36 months, it has held its ground or even appreciated against the currencies of the other five countries that make up the list of the top ten U.S. import suppliers. Until the start of 1987 the dollar was up slightly against the dollar of Canada, the number-two import source behind Japan, and it had also strengthened against the Taiwanese dollar and the Korean won. With Mexico's peso losing value almost daily and the Hong Kong dollar moving in synch with this country's currency, more than one-third of U.S. imports has largely escaped the effects of the dollar's decline. Add in purchases from most other developing countries and nonmarket economies plus oil imports and the figure quickly rises to over one-half.

What's more, conventional economic theory was a misleading guide to how manufacturers in Japan and Europe would react to the shift in the dollar's value. According to the textbooks, exporters should have tried to maintain profit margins by boosting the dollar prices of their U.S.-bound exports in step with the depreciation of the American currency. That was what most of their counterparts in the United States did during the strong dollar period of 1981 to early 1985. It was also the strategy Japanese businesses followed in 1978 when the dollar dropped 20 percent-plus against the yen and exporters passed through roughly two-thirds of this change in the form of higher prices. This time around, however, major suppliers in both Japan and Europe have opted for a different game plan: to protect their stake in the key U.S. market by hiking export prices as little as possible.

Just how little or much of the dollar's decline have foreign suppliers passed through by raising export prices? Looking at the period from the dollar's peak to September 1987, the Department of Labor's Bureau of Labor Statistics calculated the average pass-through (excluding fuel imports) at 46.5

percent. Put the other way, overseas manufacturers absorbed about one-half of the dollar's realignment. But like most averages, BLS's pass-through figure masked considerable variation among major import product groups. At the upper end were professional, scientific and controlling instruments, where 76.7 percent of the dollar's drop showed up in higher U.S. import prices, metalworking machinery (75.6 percent) and general industrial machinery (71.2 percent). Automotive products and parts were somewhat above the average with a pass-through ratio of 55.3; so was specialized industrial machinery (59 percent). Far behind were electric machinery (38.8 percent), computer equipment and other office machines (37.1 percent), steel (17.2 percent) and telecommunications equipment, including consumer electronics products (11.4 percent).

These differences are graphic evidence that market share considerations have dictated the U.S. pricing strategies of major foreign competitors. Japanese and European exporters have passed through only a fraction of the dollar's fall against their currencies in industries where there is stiff competition from third-country suppliers, particularly in the newly industrialized countries of Asia and Latin America. Consumer electronics is a prime example. U.S. import price hikes have been limited as well in product groups like computers because of the strength of American rivals and their decision to hold the line on price increases. Conversely, automotive makers and other domestic manufacturers that have raised prices to boost profit margins have given Japanese and European exporters maneuvering room regardless of U.S. market conditions. But above-average pass-through ratios are also characteristic of industries where foreign suppliers are the main players -- machine tools, for example.

The one question the BLS study does not tackle directly is how suppliers in individual countries, particularly Japan, have changed their U.S. prices in the wake of the dollar's depreciation. The issue of Japanese export pricing has increasingly preoccupied Reagan administration trade policymakers and American corporate executives. The dollar has dropped 50 percent against the yen since February 1985, yet the bilateral trade deficit is just now showing signs of reversing course, having expanded from \$18.1 billion in 1981 to \$49.8 billion in 1985 and on to \$59.8 billion last year. The U.S. trade account with West Germany has also continued to deteriorate despite a dollar-mark realignment that matches the shift in the dollar-yen exchange rate, while larger deficits in 1987 trade were posted as well with Mexico, Taiwan, Korea and several other major import suppliers. Japanese exporters have been singled out, though, because they generally represent the cutting edge of foreign competition.

The prices of Japanese-made products shipped to the United States have gone up despite industry's attempt to maintain market share. That is intuitively obvious from the BLS data. But there is more direct evidence. On average Japanese manufacturers passed through 58.1 percent of the dollar's decline in the form of higher prices for their worldwide exports during the September 1985-November 1987 period (see Table 1). This statistic, which is the result of a different and admittedly less sophisticated methodology than BLS's, does double duty as a proxy for the pricing response of Japanese companies selling to the United States, the destination for nearly two-fifths of Japan's exports. If anything, it understates the extent of the pass-through on U.S.-bound exports since the prices of products coming here have been boosted by bigger margins than those shipped elsewhere.

Table 1: Extent of Dollar's Depreciation Passed Through in Japanese Export Prices,
September 1985-November 1987

Product Line	Pass Through	Product Line	Pass Through
Transportation Equipment	60.9%	Precision Instruments	57.1%
Motor Vehicles	62.3	Scientific and Optical Equipment	67.8
Cars	63.9	Cameras	84.4
Trucks and Buses	54.5	Copiers	68.0
Automotive Parts	62.9	Watches and Clocks	43.0
Motorcycles	69.2	Audio and Video Recorders	32.7
Ships and Boats	6.8	Video Cassette Recorders	10.2
Electric Machinery	71.2	Steel	31.8
Electric Power Apparatus	100.2	Bars, Rods, Shapes and Sections	45.7
Insulated Wire and Cable	90.6	Plates and Sheets	26.1
Television Sets	57.6	Hoops, Strip and Coils	38.4
Color Television Sets	64.5	Pipes, Tubes and Fittings	31.0
Radio Receivers	88.3	Nonferrous Metals	40.5
Other Telecommunications Equipment	49.5	Copper and Copper Alloys	41.4
Microphones, Loudspeakers		Fabricated Metal Products	64.0
and Amplifiers	49.0	Structural Parts and Structures	44.6
Appliances	51.5	Hand and Machine Tools	80.1
Electronic Tubes and Semiconductors	53.3	Organic Chemicals	45.1
Integrated Circuits	73.2	Inorganic Chemicals	30.3
Nonelectric Machinery	61.8	Plastics and Resins	41.6
Internal Combustion Engines	62.6	Tires	24.5
Agricultural Machinery	41.9	Paper and Paper Products	46.0
Calculators	75.9	Tableware	62.8
Computers and Peripheral Equipment	43.5	Textile Fibers	41.1
Metalworking Machinery	73.4	Yarn	45.5
Textile Machinery	74.1	Synthetic Yarn	41.2
Construction and Mining Machinery	30.7	Fabrics	50.8
Heating and Cooling Equipment	142.5	Cotton Fabrics	61.9
Pumps and Centrifuges	34.4	Synthetic Fabrics	47.5
Mechanical Handling Equipment	94.2	Apparel	64.1
Bearings	48.9	Fish and Fish Products	42.6
		Total Exports	58.1

Note: The dollar depreciated 42.3 percent against the yen between September 1985 and November 1987 based on the rates the Ministry of Finance used to convert the export figures from yen to dollars.

Source: Calculated from Japan Tariff Association, The Summary Report: Trade of Japan.

In some respects the numbers in Table 1 raise as many questions as they answer, starting with the obvious: how can Japanese exporters absorb roughly 40 percent of the dollar's decline against the yen over an extended period of time? The standard reply is by cutting production costs. Americans generally dismiss this explanation as self-serving since it flies in the face of the conventional wisdom that Japanese manufacturers are among the world's most efficient producers, but they are reacting too hastily. The fact of the matter is that with Japanese imports priced in dollars, the 50 percent decline in the American currency has sliced the yen costs of the huge volume of industrial inputs manufacturers buy from abroad. It has also triggered an unparalleled campaign in one export-oriented company after another to find additional ways to lower the break-even point.

Coping with the Dollar's Decline

A study of Japanese export pricing completed recently by the Ministry of International Trade and Industry contained an eye-catching statistic: the drop in the dollar plus the decline in international oil prices between the third quarter of 1985 and the same period of 1987 cut the costs of materials used by Japan's manufacturing sector by 14.7 percent and overall production costs by 10 percent. Although the ministry's supporting documentation has not been released, the big fall in Japanese import prices (see Table 2) gives some idea of how manufacturers have effortlessly lowered materials costs, which represent an estimated 55 to 60 percent of total production costs on an industry-wide basis.

Table 2: Changes in Japan's Yen-Based Import Prices, 1985-87

	<u>1985</u>	<u>1986</u>	<u>1987</u>
Total	-2.4%	-44.2%	-8.3%
Food and Feed	-9.8	-24.5	-15.2
Textiles	-6.6	-18.4	0.4
Metals	-4.8	-23.3	-2.5
Wood, Lumber and Related Products	-6.8	-21.9	14.3
Petroleum, Coal and Natural Gas	0.4	-49.6	-12.5
Chemicals	-5.2	-27.8	-10.5
Machinery and Equipment	-2.3	-21.9	-8.5
Miscellaneous	-6.6	-19.6	-1.4
Reference			
Raw Materials and Fuels	-1.3	-45.2	-8.8
Light Industrial Products	-1.3	-11.2	0.8
Heavy Industrial Products and Chemicals	-3.7	-21.7	-6.4

Source: Bank of Japan

Not surprisingly, a substantial part of the savings on input costs has come from oil. The landed price of a barrel of oil was \$27.37 in September 1985; in November of last year it was \$18.40 -- a 32.8 percent reduction. In

yen terms, though, the difference was a whopping 61.1 percent. With deliveries averaging 249.9 million barrels a month during this period, the cumulative savings in Japan's import bill added up to nearly ¥10.7 trillion (\$85.4 billion at ¥125=\$1.00). Electric utilities, which depend on oil for two-fifths of their power generation, did not pass on all of this bonanza, but electricity rates for industrial users have been cut three times (June 1986, January 1987 and this past January) for a total reduction of 22.1 percent. Steel makers, petrochemical producers and other manufacturers that use naphtha and heavy fuel oil in the production process or as a fuel apparently got a bigger price break from Japanese oil refiners.

World prices for the long list of other industrial inputs that Japan imports in volume -- iron ore, aluminum, copper, pulp, logs, cotton, wool, rubber, coal and liquefied gas -- have generally gone up over the last three years or so, denying manufacturers the double bonus obtained from oil imports. Yet the decline of the dollar alone has lowered the value of purchases from abroad by several trillion yen, a major source of savings given the fact that imports supply about 70 percent of the raw materials other than fuels used by Japanese manufacturers and probably a similar proportion of the much larger consumption of semi-finished goods.

While the weaker dollar has cut the costs of imported inputs, it has not been much of a factor in reducing the expense of parts and other intermediate products, undoubtedly the biggest materials costs incurred by the vast group of export-oriented companies in the machinery and transportation equipment industries. True, a steadily increasing number of manufacturers are sourcing components and subassemblies from offshore, both from their own plants and from foreign suppliers, but the impact on costs is still marginal. Through their own initiatives, however, automotive, electronics and nonelectric machinery makers have achieved substantial savings on intermediates, primarily, anecdotal information suggests, by working with their extensive network of parts subcontractors to find ways to lower the prices charged.

Japanese industry's cost-cutting campaign has been targeted equally at personnel expenses, which account for another 15 percent or so of total production costs. Unit labor costs, already falling on a sector-wide basis, have been trimmed farther. Labor productivity, which increased by 19 percent in the first half of the 1980s, went up an additional 12 percent in the 1985-87 period (see Table 3), facilitated mainly by continuing changes in production processes, including more automation, but also by redesigning products to require less labor input. At the same time, management has taken an increasingly hard line on wage hikes, keeping raises below productivity gains, particularly in 1987.

Corporate planners have also found ways to decrease the expenses that make up the other 25 to 30 percent of aggregate production costs. To cite just one example, manufacturers have reduced inventories of inputs and intermediate products and stocks of finished goods. Moreover, the same stringent controls applied to production costs have been extended to selling expenses, including salaries and commissions, and to general and administrative costs, which cover such expenses as office salaries, office supplies, and heat and light.

Table 3: Changes in Wages and Labor Productivity in Japan's Manufacturing Sector, 1985-87

	<u>Wages</u>			<u>Labor Productivity</u>		
	<u>1985</u>	<u>1986</u>	<u>1987</u>	<u>1985</u>	<u>1986</u>	<u>1987*</u>
Total	4.0%	2.4%	2.5%	4.2%	2.2%	5.5%
Foods and Tobacco	3.8	7.3	3.3	-0.9	1.8	-2.1
Textiles	3.5	2.0	3.4	1.9	0.9	2.5
Apparel	0.4	1.8	3.3	1.6	-0.1	-1.5
Lumber and Wood Products	5.5	5.4	4.3	5.1	13.2	-6.4
Pulp and Paper Products	5.6	2.6	3.0	6.3	5.6	7.9
Chemicals	3.6	3.4	4.2	3.2	0.9	9.0
Petroleum and Coal Products	6.2	3.6	3.8	-0.6	3.0	4.0
Nonmetallic Mineral Products	4.0	4.0	3.1	1.7	-0.5	5.3
Steel	5.0	0.3	-1.6	4.4	-2.4	6.8
Nonferrous Metals	4.8	2.8	2.8	0.9	0.6	6.0
Fabricated Metal Products	3.1	4.1	1.2	7.1	0.5	5.4
Nonelectric Machinery	4.1	-0.1	1.6	6.1	-5.2	2.4
Electric Machinery	1.9	1.6	4.4	10.2	4.7	10.5
Transportation Equipment	4.8	1.6	1.4	2.8	0.1	-0.7
Precision Instruments	6.3	0.9	1.3	17.1	10.1	2.9

*Ten months only.

Source: Ministry of Labor and Japan Productivity Center

However small, all of the cost-cutting steps export-oriented manufacturers have taken since the dollar began its drop against the yen are starting to add up to significant savings in operating expenses. Yet these savings offset only part of the currency realignment not passed through in the form of higher export prices. Exporters have therefore had to sacrifice short-term profits to maintain share in the U.S. market. The record or near-record profits earned during the 1984-85 export boom left companies in good shape to pursue this strategy in 1986 and the early part of 1987 (see Table 4). Since then operating income margins have improved -- thanks in large part to expanded sales at home but also because of additional export price hikes and increasing returns from the stringent cost controls implemented earlier.

Japanese Export Pricing Under Attack

The success of export-oriented companies in coping with the shift in the dollar-yen exchange rate has created new trade tensions with the United States. In one U.S. industry after another there is talk that Japanese manufacturers must be dumping -- selling products here for less than in Japan or, in some cases, below production costs -- since their U.S. prices have not gone up by the full margin of the currency realignment. Commerce Secretary C. William Verity added an official warning last November, telling Japanese companies that by failing to raise prices in line with the dollar's drop they risked being charged with dumping. Making sure the message got through, he confirmed that the department was looking into the possibility of dumping in a variety of products.

Table 4A: Income Statement for Corporations in Japan's Manufacturing Sector, FY 1980-FY 1986

(in billions of yen)

	FY 1980	FY 1981	FY 1982	FY 1983	FY 1984	FY 1985	FY 1986
Sales	Y262,572	Y283,623	Y279,853	Y298,582	Y309,618	Y333,797	Y324,927
Cost of Goods Sold	214,122	231,490	227,330	242,253	249,199	269,176	314,388
Selling and General and Administrative Expenses	35,036	38,730	40,864	44,237	46,252	51,500	10,539
Operating Income	13,414	13,403	11,659	12,093	14,167	13,121	
Non-operating Income							
(Expenses)	(3,938)	(5,005)	(3,889)	(3,436)	(3,157)	(2,324)	n.a.
Current Income	9,477	8,398	7,770	8,656	11,010	10,797	n.a.
Extraordinary Profits and Losses	15	278	315	321	1	78	n.a.
Pretax Income	9,491	8,675	8,084	8,977	11,011	10,875	n.a.
Provision for Income Taxes	4,692	4,891	4,427	5,025	6,097	5,917	n.a.
Net Earnings	4,800	3,785	3,657	3,952	4,915	4,958	n.a.
Profit Margin	1.8%	1.3%	1.3%	1.3%	1.6%	1.5%	n.a.

Note: The yen figures can be converted into dollars using the following average exchange rates: FY 1980, Y217.25; FY 1981, Y227.52; FY 1982, Y249.64; FY 1983, Y236.33; FY 1984, Y244.19; FY 1985, Y221.09; and FY 1986, Y159.84.

Source: Ministry of Finance

Table 4B: Profit Margins in Japan's Manufacturing Sector*

	FY 1980	FY 1981	FY 1982	FY 1983	FY 1984	FY 1985	FY 1986
Total	5.1%	4.7%	4.2%	4.1%	4.6%	3.9%	3.2%
Food Products	3.6	3.6	3.2	3.6	3.3	3.3	3.6
Textiles	3.5	3.1	2.7	2.8	3.4	3.0	2.6
Pulp and Paper Products	5.2	5.8	4.3	4.4	5.2	4.6	4.9
Chemicals	6.1	5.3	5.3	6.1	6.2	6.0	6.1
Steel	8.0	7.5	5.0	3.1	6.1	3.9	1.0
Nonferrous Metals	5.5	4.0	2.7	3.6	3.5	2.4	2.3
Fabricated Metal Products	4.8	4.2	3.3	2.6	4.8	4.4	4.0
Nonelectric Machinery	6.6	6.0	5.2	4.3	4.7	4.6	3.2
Electric Machinery	6.0	6.3	5.7	5.7	6.2	4.5	2.7
Transportation Equipment	4.2	3.5	3.3	3.3	3.7	4.0	2.8
Precision Instruments	7.7	6.6	6.9	5.9	6.3	5.6	2.5

	1985				1986				1987		
	I	II	III	IV	I	II	III	IV	I	II	III
Total	4.9%	5.3%	4.0%	4.2%	3.7%	3.8%	3.1%	4.1%	3.6%	4.4%	4.3%
Food Products	2.3	4.7	4.6	5.3	2.5	4.5	4.0	5.1	2.2	4.3	4.6
Textiles	4.1	4.2	2.9	3.3	3.5	2.3	3.7	3.8	4.5	5.4	5.4
Pulp and Paper Products	4.9	5.0	4.0	4.3	4.1	6.2	4.8	5.9	4.5	5.9	4.7
Chemicals	5.7	6.8	5.9	6.4	5.9	6.4	6.2	7.5	6.5	7.8	7.4
Steel	6.4	5.6	4.2	3.8	2.6	1.2	0.3	1.6	0.6	2.9	4.2
Nonferrous Metals	3.8	3.3	2.2	2.3	1.8	2.8	2.3	2.8	3.4	3.2	3.4
Fabricated Metal Products	6.3	6.7	4.7	4.3	4.4	5.3	4.4	4.5	5.9	4.1	4.5
Nonelectric Machinery	6.3	6.5	5.1	3.7	4.4	4.8	3.7	3.2	3.2	3.5	4.8
Electric Machinery	6.6	5.9	4.8	4.0	3.8	2.5	2.4	2.0	3.1	2.5	3.5
Transportation Equipment	3.4	5.6	3.5	3.9	2.7	2.4	1.7	2.7	2.4	2.9	3.1
Precision Instruments	6.7	7.2	5.6	5.4	5.8	4.9	3.0	2.6	3.8	3.0	4.0

*Margins reflect the ratio of operating income to sales. Operating income is derived by subtracting the cost of goods sold and selling, general and administrative expenses from sales.

Note: The fiscal year figures include all corporations in the manufacturing sector while the quarterly numbers cover corporations capitalized at ¥10 million (\$80,000 at ¥125=\$1.00) or more.

Source: Ministry of Finance

Japanese manufacturers are perplexed by all the dumping allegations. Major exporters have repeatedly said that they have covered the dollar's drop through a combination of higher export prices, lower operating costs and thinner profit margins. MITI came to the same conclusion in its export pricing study. Ministry spokesmen acknowledge that there might be individual exceptions, but say the only thing exporters as a group can be faulted for is not always adjusting prices fast enough during periods of rapid change in the dollar-yen rate.

Government and industry officials in Japan raise an interesting question in responding to the U.S. criticism: if Japanese exporters are assumed to be selling here at less than fair value, why have so few antidumping petitions been filed? Eight proceedings were initiated in 1986 and six last year -- hardly an indication of the widespread dumping alleged by American producers since eight investigations were also started in 1983 followed by four the next year and five in 1985.

The standard reasoning in Washington is that the cost of pursuing a dumping complaint and the year-plus time frame for most investigations have discouraged U.S. manufacturers from filing. This might be true in some instances, but another explanation seems closer to the mark. No matter how airtight the case, an American company or group of producers is not going to charge its affiliates and suppliers with dumping -- and that is what many major Japanese exporters are.

For further information, contact Susan MacKnight.

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The views expressed in this report are those of the author and do not necessarily represent those of the Japan Economic Institute.

J A P A N · E C O N O M I C · I N S T I T U T E

J E I

R E P O R T

A Two-Part Report: A and B

NO. 10B
March 11, 1988

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LDP Mulls New Taxes As Opposition Pushes For Cuts

In what is beginning to look like a replay of last year, the Diet is locked in debate over the fiscal 1988 tax plan. On one hand, the ruling Liberal Democratic Party is focusing on the need to build a solid revenue base to meet the sharply higher welfare costs expected by the end of the century. On the other, opposition parties focusing on the relatively low standard of living and already high income-tax burden call for a sizable tax cut and no new levies. Diet business has already been delayed one day over the tax issue, forcing the final lower house vote on the FY 1988 spending package to be postponed until March 10. If neither side blinks, however, the spending bill could be in jeopardy and the government may be forced to seek the equivalent of a continuing resolution, as it did last year.

Twice in the recent past the LDP has tried and failed to push major new taxes through the Diet. Prime Minister Masayoshi Ohira made a tax increase a

bend have failed. While there are those in the LDP who argue that the party must pass a new indirect tax for the long-term good of the nation, the recent loss of a by-election in Osaka for a lower house seat to a Japan Communist Party candidate who opposed any form of sales tax should serve as ample warning to Mr. Takeshita and his party.

The tax increase conundrum has become more difficult since the LDP agreed March 6 to the opposition parties' income tax cut proposal in order to end the boycott of the Diet. Thanks to extraordinary revenues and economic growth, the government may indeed be able to absorb the short-term impact of a Y2.9 trillion (\$23.2 billion) tax cut without new taxes. Over the long term, however, new revenue sources must be developed. It is not at all clear that Mr. Takeshita can succeed where others have failed before.

Jon Choy

Japanese Corporate Profits Recovering

While Japanese corporate profits are rising, the strong yen is not helping, despite some claims to the contrary. According to the Ministry of International Trade and Industry, the currency's appreciation has led to lower industrial and agricultural input prices and kept profits from falling further in fiscal 1986, but this development has been less important during the current fiscal year than the positive effects of increased production volume. The ministry notes that profit growth in export-dependent industries such as steel and electric machinery has lagged other industries by about three months.

But a new study by Fuji Bank, Ltd. appears to contradict MITI's conclusion that the soaring yen has not helped profitability, at least the profitability of domestic sales in certain industries. The bank looked at nonelectric machinery, electric machinery, precision equipment and transportation equipment and found that they have benefited from a 6.9 percent drop in the cost of fuel and raw materials since early 1985. The savings have not been fully passed on to domestic customers, however, raising the sales-to-purchase cost index (see Table). Prices to foreigners in yen, although not in dollars, have declined relative to the cost of materials and fuel. Taking foreign and domestic sales together, the effect of the higher yen has been to increase profit margins, although the higher dollar prices of exports could have reduced export volume, pulling down overall profits. Fuji Bank predicts that these four industries will face increasing competition from imports and will have to lower domestic prices in the coming months, leading to downward pressure on profits.

Some analysts have argued that for part of the period since the yen started rising, corporate income was maintained by securities trading and other financial activities, or zaitech. According to this argument, underlying profitability has actually been much worse than it appears since zaitech profits are normally unsustainable, a point driven home by the October stock market crash. While MITI does not deny that zaitech made a difference in a few cases, it suggested that the profit recovery is overwhelmingly based on other factors, especially increasing domestic sales.

Sales-to-Purchase Cost Index
for Selected Machinery Industries

(July-September 1985=100)

October-November 1987

Exports	90.8
Domestic Sales	103.5
Total Sales	100.4

Source: Fuji Bank, Ltd.

Most financial institutions and economic forecasters expect profits to keep rising throughout the economy. In a new forecast of recurring profits for firms other than financial and gas companies listed on the first section of the Tokyo Stock Exchange, Yamaichi Research Institute sees higher profits in fiscal 1987, the first increase in three years, and a further rise of 9.3 percent in FY 1988, roughly in line with many other forecasts. NRI & NCC Co., Ltd. (formerly Nomura Research Institute), for example, is forecasting a healthy 16.3 percent rise for its sample of first-section TSE firms and, within that sample, manufacturing profits are expected to surge 20 percent.

Nomura's data show that many large Japanese firms are still behind their positions prior to the rapid rise in the yen that began in the first half of fiscal year 1985, although companies in the nonmanufacturing sector are ahead (see Table). Using Nomura's forecasts, profits in the manufacturing sector will still lag behind FY 1984's a year from now.

Douglas Ostrom

Recurring Profits of Japanese Firms, FY 1985-FY 1988

(FY 1984 = 100)

	<u>FY 1985</u>	<u>FY 1986</u>	<u>FY 1987*</u>	<u>FY 1988*</u>
Manufacturing sector	74	51	76	91
Nonmanufacturing sector	95	94	103	109
All industries	80	62	83	97

*Projected by NRI & NCC Co., Ltd.

Note: Excludes electric utilities and oil companies.

Source: Calculated from data in Nomura Quarterly Economic Review.

J A P A N · E C O N O M I C · I N S T I T U T E

JEI

R E P O R T

A Two-Part Report: A and B

NO. 11A

March 18, 1988

JAPAN'S ENERGY POLICY: 1987 UPDATE

Summary

Once again, changes in the price of oil and the yen-dollar exchange rate wreaked havoc with Tokyo's energy policies last year. Unlike 1986, though, the two factors worked against each other rather than in concert with one another. While industrial and residential users continued to benefit from falling energy prices, government policymakers wrestled with lower oil tax revenues and shifting energy program priorities. An unexpected obstacle disrupted one area of international cooperation when congressional unease derailed quick ratification of a new bilateral nuclear fuel treaty. Despite these setbacks, Japan's energy policy remains firmly on the road to greater efficiency and less dependence on fossil fuels.

The Big Picture

According to the Ministry of International Trade and Industry, Japan consumed less energy of all types between April 1986 and March 1987 while overall supplies fell 1.1 percent (Table 1). The decline in consumption was primarily attributable to an economic slowdown as the country adjusted to the stronger yen; real gross national product growth dropped to 2.6 percent, down from 4.4 percent in FY 1985. Crude oil purchases continued to decline (see Table 2), thanks partly to rising imports of gasoline and kerosene made possible by a more liberal government policy (Table 3).

Table 4 shows the conflicting trends in world crude oil prices and in the yen-dollar exchange rate. Rising global consumption and a restoration of

some semblance of production discipline by the Organization of Petroleum Exporting Countries pushed the dollar price of oil from just under \$15 a barrel in January 1987 to almost \$18.50 in November, a 23 percent increase. On the other hand, the yen's appreciation against the dollar helped to cushion the impact: prices in yen terms rose just 6.9 percent. The upturn quickly worked its way through to the wholesale and retail levels, but prices near the end of 1987 remained below the 1986 averages in nearly all cases (see Tables 5 and 6).

The prices of other energy imports were mixed, revealing the impact of oil's changing price competitiveness and long-term programs to promote alternative sources. On the import side (Table 7), coal fell back in 1986 from 1985's record volume and then leveled off last year, primarily due to flat demand from steel producers. The trend in heavy fuel oil imports can be laid to efforts to convert to other energy sources. Naphtha purchases, which jumped strongly in 1986, rose again in 1987, in part because the decline in world oil prices improved the competitiveness of Japan's petrochemical industry, which uses naphtha as both a feedstock and a fuel. As for consumption (Table 8), it seems that industrial and residential users increasingly favor the liquid alternative: imports and usage of both liquefied natural and petroleum gases have continued to grow.

Electricity output figures (Table 9) reveal that both hydroelectric and thermal energy supplies shrank in 1986 and again last year. Although the decline in hydroelectric power was less severe than the drop in 1984 caused by drought, it highlighted the inherent instability of this source. The reduced contribution from thermal sources reflected the slow but steady shift toward nuclear power. The gain in nuclear power generation, however, appears to be the result of an increase in operating rate (from an average of 74.2 percent in 1986 to 76.2 percent in 1987) rather than capacity, since no new plants came on line.

Total electricity consumption fell in 1986 from 1985's record level, mainly due to a sharp drop in manufacturing demand (Table 10). The steel and chemical industries together accounted for 8.42 billion kilowatt-hours of the 11.7 billion kilowatt-hour decline in industrial demand. While these two industries appear to have recovered somewhat in the first nine months of 1987 (the latest period for which data are available), they still lag behind the growth of overall manufacturing consumption. Demand for lighting, however, showed a solid gain in 1986 and an even sharper upturn at the end of 1987, thanks to a jump in residential demand.

In fact, households were clearly unaffected by the yen's rise in terms of energy consumption in 1986, while the opposite was true of industry (see Tables 11 and 12). Residential use of all modern fuels has risen steadily, while demand for coal and other solids (charcoal and briquettes) continues to dwindle. On the industrial side, demand bounced back from 1986's lows to set a new record in 1987 even though the conservation drive remained in high gear and several major energy-using industries continued to be phased back, particularly mining and nonferrous metals.

Policy Problems

While cheaper energy has been a boon to industry it is a problem for government planners, since lower prices mean lower tax revenues. Revised estimates of fiscal 1987 revenues from taxes on gasoline, liquefied petroleum gas, aviation fuel and petroleum are unchanged from initial estimates; however, officials expect a revenue shortfall, particularly with regard to gasoline tax receipts. This is tacitly acknowledged in the 17.7 percent drop in FY 1988 estimates of gasoline tax revenues, continuing a slide that began in fiscal 1985. Petroleum tax revenues show a similar though sharper fall. Tax receipts from crude oil imports plunged from Y400 billion (\$3.2 billion at Y125=\$1.00) in fiscal 1985 to Y190 billion (\$1.5 billion) two years later. Tax planners have opted to raise the tax rate in an effort to stem the decline, and FY 1988 receipts are projected to rise 52.6 percent to Y290 billion (\$2.3 billion). Oil companies have lobbied against the tax increase but it appears that their efforts will not be successful.

While the reduced receipts are balanced in some cases by lower outlays, particularly for building strategic reserves and price control programs, Tokyo remains committed to certain energy programs. Although the overall general account budget for fiscal 1988 calls for a 6.8 percent decline in energy programs, a detailed inspection of the energy budget is revealing. Funds for the following programs will be cut: developing new sources of crude oil (5.1 percent); restructuring the domestic oil industry by encouraging mergers and plant closings to reduce capacity (5.5 percent); restructuring the domestic coal industry by similar means (17.9 percent); and developing coal-related technologies (26.6 percent). On the other hand, allocations for more energy-efficient equipment will rise 36.8 percent, funds for adding electric generating capacity will jump 13.8 percent, and outlays for alternative energy development will increase 5.3 percent.

Tokyo should be able to employ an energy budget strategy of "taking from Peter to pay Paul" for at least the next few years thanks to two previous decisions. Funds now spent to support the ailing coal industry will be freed by FY 1991, by which time a 47.5 percent reduction in domestic output is planned. Coal industry programs account for about 15.5 percent of energy program outlays. Another block of funds will be available as Tokyo loosens controls on imports of refined petroleum products. After great controversy, imports of gasoline and kerosene (which is still used in many homes for heat and light) were permitted beginning in 1986. The program has been popular, particularly after the yen's appreciation sharply increased the price competitiveness of foreign refined products. If the liberalization program is expanded, a significant share of the funds related to crude oil imports (which now account for 46.1 percent of the total energy budget) could be redirected.

New Long-Term Energy Outlook

The strong yen has an even broader impact on energy policy than prices and tax revenues, however. The currency realignment has spurred the restructuring of Japan's economy from export-dependent to domestic demand-driven, and accelerated the transition to the post-industrial stage of economic growth. The shift away from exports will rearrange Japan's industrial structure and the composition of energy demand and consumption. Economic maturity promises to

reduce total energy demand, since a greater proportion of growth will come from services and high technology, both less energy-intensive than traditional manufacturing.

Responding to these shifts, the Ministry of International Trade and Industry has drawn up a new long-term outlook for energy demand and supply (see Tables 13 and 14). When compared with the 1983 outlook, several aspects of the new forecast stand out. First, overall energy demand is expected to grow at a much slower rate. Similarly, the role of fossil fuels is expected to shrink more slowly, indicating that planners think supplies will remain abundant. Coal will play the same role on a percentage basis, but the absolute amount consumed is expected to drop significantly. Finally, the outlook for nuclear power is slightly less rosy than before. This may be due to the impact of the Chernobyl disaster, but it could also be an admission that the major issue of fuel reprocessing will remain unresolved.

Nuclear Power: Keystone or Achilles Heel?

The one budget spending category that is likely to be reduction-proof is nuclear power, and in particular nuclear safety. The reactor meltdown at the Soviet Union's Chernobyl plant prompted a wave of anxiety in Japan. The government tried to calm public fears by pointing out that Japan did not have any plants that were similar to Chernobyl's, and that Japan's safety record was one of the best in the world. Nevertheless, expenditures for safety programs will rise 11.5 percent in the coming fiscal year, far more than the 6.3 percent increase in the overall budget for nuclear power. The only other area to receive more funding in fiscal 1988 is nuclear fuel cycle research; outlays for development and construction of experimental reactors will remain unchanged.

The overall health of the nuclear power industry is unquestionable. While no new reactors are planned in the United States, 18 are on the drawing board in Japan. The total amount of power generated by nuclear plants is expected to jump 53.7 percent in Japan by the year 2000, compared with an 8.6 percent increase in the United States. To be sure, Japan's nuclear industry will remain small in absolute terms in comparison to this country's (total U.S. generating capacity is presently four times greater and will still be twice as large in 2000), but it is much more active. Development of breeder reactors, advanced thermal reactors and improved fuel enrichment and recovery technologies are proceeding apace in Japan, while U.S. programs languish. On a more down-to-earth level, Japanese experience at building and designing nuclear plants and equipment will continue to advance, thanks to the numerous plants planned at home and abroad. U.S. companies, facing a dearth of domestic orders, will have fewer opportunities to improve their skills.

In the face of this growing competence, many analysts fear that Japan will emerge as the world leader in nuclear technology in the near future. Just as Washington has been able to influence the nuclear industries of other countries by regulating how, when and where U.S. nuclear equipment and fuel is used, so Tokyo may have such power in the future. This appears ominous to some Americans, particularly against the background of the Toshiba Machine Co., Ltd. affair. To others, the possibility that Tokyo will be able to control components in the next generation of U.S. reactors that are built is of equal concern.

U.S.-Japan Nuclear Cooperation Agreement

All these pressures are evident in the debate over whether Congress should ratify a new bilateral nuclear cooperation agreement submitted by the administration. The main points of the new pact include: blanket approval of Japanese reprocessing of nuclear fuel obtained from the United States; adequate precautions against terrorist and other threats in transporting the fuel; stronger Japanese controls on the use of plutonium; and reciprocal rights over nuclear fuel and technology. From the White House's point of view, the treaty is technically sound and satisfies the demands of security. As far as Tokyo is concerned, the agreement insulates the recycling process from the vagaries of American politics. At present, the Department of Energy must approve reprocessing requests on a case-by-case basis. Approval times are currently well under a year, but have been substantially longer under previous administrations. The new accord also offers some defense against arbitrary control of U.S. technology by providing Tokyo similar rights over Japanese know-how.

Congress, however, is unimpressed with the pact. To prevent the treaty from coming into force in mid-April, both houses must reject it. The issue of physical safety during transport (insuring that the nuclear fuel containment vessel does not break in the event of an airplane crash) and transport routes (Alaskan airspace would be traversed during flights from Japan to European reprocessing centers) has gained wide attention. While these concerns are valid, they mask the real issue: U.S. reluctance to give up control over nuclear fuel and all it represents. The distrust of Tokyo when it comes to matters that influence American security or relate to leading-edge technologies is almost palpable on the Hill. The first evidence of congressional reticence was the approval of an amendment to a vital budget bill prohibiting overflights of plutonium unless a panel of experts deems the transport vessel crash-proof (see JEI Report No. 1B, January 8, 1988). The pact really encountered difficulties in the Senate Foreign Relations Committee, which voted to report the treaty to the full Senate with an unfavorable recommendation (see JEI Report No. 4A, January 29, 1988).

The Senate is now trying to decide what to do with the bill. An outright rejection would worsen already poor relations with the White House, yet several influential senators feel the bill in its current form is unacceptable. Neither can the Senate simply ask the administration to renegotiate the pact unless it has a clear idea of what needs to be changed. The view from the other end of Pennsylvania Avenue is equally muddy. It is unlikely that the lame-duck administration can force the Senate to adopt the treaty, so it is trying to reassure senators that their concerns can be met within its framework. On March 10 the administration proposed a polar route that avoids all inhabited territory and is within the range of Boeing Co.'s latest aircraft. It is not at all certain that such a soft-sell will work; Senate opponents have dismissed the new route and will call for debate on rejecting the treaty.

Tokyo could become frustrated with the entire process, although it has no alternative but to persist. If the treaty is not ratified, the existing treaty will remain in force. While it is not ideal, it does allow Tokyo to continue its nuclear development program. The nuclear pact, which could contribute to bilateral harmony, has instead become a victim of bilateral discord.

Conclusion

Tokyo has moved aggressively to deal with some of the forces upsetting its energy policies: the strong yen, industrial restructuring and unstable global energy markets. Other problems have proved more resistant to quick solutions, particularly budget priorities and the bilateral nuclear agreement. Tokyo remains confident, however, that its emphasis on conservation, diversification and development of alternatives remains the right course.

For further information, contact Jon Choy

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The views expressed in this report are those of the author and do not necessarily represent those of the Japan Economic Institute.

Table 1: Japan's Energy Supply by Source

(in millions of units)

	FY 1985			FY 1986			
	Crude Oil			Crude Oil			Percent
	<u>Actual</u>	<u>Equivalent</u>	<u>Share</u>	<u>Actual</u>	<u>Equivalent</u>	<u>Share</u>	<u>Change</u>
Oil (kl)	248.7	248.7	56.7%	246.0	246.0	56.8%	-1.1%
Coal (mt)	110.9	83.6	19.1	103.9	79.2	18.3	-6.3
Nuclear (kw)	24.7	41.7	9.5	25.8	41.1	9.5	4.5
Natural Gas (kl)	41.3	41.3	9.4	42.8	42.8	9.9	3.6
Hydroelectric (kw)	34.5	21.7	4.9	35.8	18.2	4.2	3.8
Alternatives (kl)	1.7	1.8	0.4	5.9	6.1	1.4	247.1
Total		438.8	100.0		433.9	100.0	-1.1

Source: Ministry of International Trade and Industry

Table 2: Japan's Crude Oil Imports, Production and Inventories

(in thousands of barrels)

	<u>Production</u>	<u>Imports</u>	<u>Throughput</u>	<u>Rate of Operation</u>	<u>Inventories</u>
1980	3,177	1,615,480	1,462,123	67.3%	238,020
1981	2,868	1,448,203	1,321,353	60.9	226,302
1982	2,937	1,350,369	1,225,566	56.5	205,916
1983	3,095	1,307,024	1,181,136	56.9	185,870
1984	2,994	1,349,847	1,220,958	67.1	163,905
1985	3,931	1,247,496	1,130,973	62.3	160,288
1986	4,629	1,223,499	1,082,326	60.6	175,415
1987	4,076*	1,166,079	1,053,169	371.8	1,011,402

*Through November only.

Source: Petroleum Association of Japan

Table 3: Japan's Imports of Gasoline and Kerosene

(in 1,000 kiloliters)

	<u>Gasoline</u>		<u>Kerosene</u>	
	<u>Amount</u>	<u>Percent Change</u>	<u>Amount</u>	<u>Percent Change</u>
1985	0	--	0	--
1986	3,293	--	2,648	--
1987	4,190	27.2%	6,012	127.0%
January	259	5.7	694	631.1
February	211	164.3	536	-10.8
March	434	112.1	373	19.3
April	254	117.4	230	*
May	458	216.4	255	*
June	426	79.3	305	1,123.9
July	331	-14.3	299	155.9
August	394	5.8	608	867.3
September	200	-34.3	611	727.8
October	492	55.0	619	240.6
November	388	11.4	599	52.3
December	341	-35.2	882	12.7

*1986 imports were zero.

Source: Petroleum Association of Japan

Table 4: Price (c.i.f.) of Imported Crude Oil

	<u>Volume</u> <u>(1,000 bbl)</u>	<u>Value</u> <u>(\$ millions)</u>	<u>Dollars</u> <u>per bbl</u>	<u>Yen per</u> <u>kiloliter</u>	<u>Exchange</u> <u>Rate*</u>
1980	1,600,352	\$52,749	\$32.97	¥47,197	¥236.14
1981	1,430,623	53,343	37.29	51,387	219.10
1982	1,334,958	46,266	34.66	53,906	247.28
1983	1,302,055	40,063	30.77	45,923	237.28
1984	1,314,034	39,379	29.36	43,713	236.66
1985	1,232,494	34,600	28.07	42,374	239.97
1986	1,187,791	19,502	16.42	18,189	176.12
1987	1,162,018	20,657	17.84	16,355	146.01
January	117,239	1,757	14.99	14,994	159.01
February	104,773	1,789	17.07	16,399	152.70
March	100,942	1,791	17.75	17,131	153.47
April	102,238	1,840	18.00	16,636	146.97
May	78,474	1,423	18.13	15,957	139.91
June	80,179	1,456	18.16	16,285	142.58
July	86,720	1,580	18.22	16,940	147.81
August	87,431	1,591	18.20	17,265	150.83
September	90,475	1,664	18.39	16,543	143.02
October	94,992	1,747	18.39	16,722	144.59
November	109,641	2,017	18.40	16,029	138.52
December	108,914	2,002	18.41	15,361	132.65

*Yen per dollar

Source: Ministry of Finance

Table 5: Wholesale Petroleum Product Price Indices

(1980=100)

	<u>Gasoline</u>	<u>Naphtha</u>	<u>Jet Fuel</u>	<u>Kerosene</u>	<u>LPG</u>	<u>Fuel Oil</u>
1981	106.2	99.7	108.6	114.4	112.8	118.0
1982	114.1	101.4	121.7	131.2	129.6	124.1
1983	111.1	91.9	123.3	125.0	123.1	116.3
1984	108.6	81.1	122.0	121.2	119.4	101.8
1985	106.3	79.2	122.7	115.3	113.4	106.9
1986	94.2	45.6	98.5	86.1	83.6	72.8
1987	87.2	32.6	81.5	71.9	69.4	41.2
January	84.0	26.4	79.4	64.9	62.4	35.6
February	84.0	29.9	79.4	64.9	62.4	36.1
March	86.6	29.9	79.4	70.7	68.2	39.7
April	88.0	32.5	82.2	73.6	71.1	39.7
May	88.0	32.5	82.2	73.6	71.1	39.7
June	88.0	32.5	82.2	73.6	71.1	39.7
July	88.0	34.1	82.2	73.6	71.1	39.7
August	88.0	34.1	82.2	73.6	71.1	39.7
September	88.0	34.1	82.2	73.6	71.1	46.1
October	88.0	34.9	82.2	73.6	71.1	46.1
November	88.0	34.9	82.2	73.6	71.1	46.1
December	88.0	34.9	82.2	73.6	71.1	46.1

Source: Bank of Japan

Table 6: Consumer Prices for Petroleum Products

	<u>National Price Index</u>			<u>Tokyo Retail Price</u>		
		1980=100		Gasoline	Kerosene	Propane
	<u>Gasoline</u>	<u>Kerosene</u>	<u>Propane</u>	<u>(1 liter)</u>	<u>(18 liters)</u>	<u>(cu. m.)</u>
1981	102.6	105.8	103.7	¥157	¥1,628	¥5,079
1982	111.8	117.2	103.9	172	1,791	5,104
1983	103.2	110.4	104.6	156	1,718	5,134
1984	97.9	101.6	105.1	150	1,613	5,131
1985	94.7	93.1	105.4	146	1,494	5,104
1986	83.3	76.9	102.2	115	948	4,849
1987	80.8*	57.5*	96.5*	126	918	4,746
January	73.4	54.9	98.7	113	927	4,824
February	78.2	56.6	97.3	120	928	4,783
March	79.3	57.2	96.4	122	920	4,758
April	83.6	58.5	96.1	130	925	4,741
May	83.5	58.6	96.1	130	926	4,741
June	83.0	58.5	96.1	129	925	4,741
July	82.1	58.2	96.1	129	919	4,739
August	81.8	58.1	96.1	128	919	4,724
September	81.5	58.0	96.1	128	919	4,724
October	81.4	57.6	96.0	128	916	4,724
November	81.1	56.6	96.0	127	900	4,724
December	n.a.	n.a.	n.a.	127	890	4,724

*Through November only.

Source: Management and Coordination Agency

Table 7: Japan's Non-Crude Oil Energy Imports

(in thousands of units)

	Coal (mt)	Naphtha (kl)	Heavy Fuel Oil (kl)	LPG (mt)	LNG (mt)
1980	68,570	7,363	7,431	9,725	16,324
1981	77,959	7,241	7,404	10,097	16,833
1982	78,535	8,998	6,893	11,861	17,480
1983	75,124	13,096	7,285	10,860	18,748
1984	87,227	13,414	7,342	11,320	25,738
1985	93,448	14,896	7,493	11,540	27,556
1986	90,392	17,294	6,924	11,942	28,261
1987*	82,234	18,312	7201	11,424	26,910

*Through November only.

Source: Ministry of International Trade and Industry

Table 8: Japan's Consumption of Imported Non-Crude Oil Energy

(in thousands of units)

	Coal (mt)			Heavy Fuel Oil (kl)			LPG (mt)		LNG (mt)	
	Coke	Steel	Power	Agri- culture	Manufac- turing	Ship- ping	Power	Chemical	Motor vehicles	Residential
1980	4,309	64,440	10,208	6,433	43,747	6,154	38,360	4,485	1,548	3,180
1981	5,197	64,650	13,972	6,444	35,690	4,730	34,508	4,465	1,241	3,411
1982	4,330	62,470	15,299	6,323	30,209	4,365	30,983	4,465	1,241	3,411
1983	4,551	57,368	18,063	5,707	27,769	4,112	29,476	4,047	1,822	4,195
1984	5,014	65,963	20,306	6,086	26,655	4,909	29,220	5,029	1,843	4,195
1985	5,821	66,344	23,988	1,303	24,853	4,709	22,271	5,176	1,722	5,561
1986	5,528	62,982	23,588	1,498	24,121	4,663	19,952	5,292	1,728	5,589
1987	4,326	54,381	21,600	1,299	20,246	3,930	15,462	4,556	1,278	6,228
									1,278	5,897
									2,964	20,046

*The figures for coal and liquefied natural gas are through November. The numbers for heavy fuel oil and liquefied petroleum gas go through October only.

Source: Ministry of International Trade and Industry

Table 9: Output of Electric Utilities in Japan

(in billions of kilowatt-hours)

	<u>Total</u>	<u>Hydro</u>	<u>Thermal</u>	<u>Nuclear</u>
1980	514.05	85.15	346.90	82.01
1981	523.14	83.74	352.18	87.23
1982	522.48	77.34	343.30	101.84
1983	555.49	81.39	360.98	113.12
1984	580.41	70.65	378.32	133.23
1985	603.93	81.19	363.75	158.98
1986	601.51	79.55	354.65	167.31
1986: I-III	455.30	64.18	264.33	126.43
1987: I-III	469.56	62.80	268.84	137.93

Source: Ministry of International Trade and Industry

Table 10: Japan's Electricity Consumption

(in billions of kilowatt-hours)

	<u>Total</u>	<u>Light</u>	<u>Total</u>	<u>Power</u>			<u>Rail-roads</u>
				<u>Total</u>	<u>Manufacturing</u>		
					<u>Chemicals</u>	<u>Steel</u>	
1980	464.25	105.27	353.98	190.77	26.79	61.80	12.71
1981	470.56	110.30	360.27	184.29	26.28	58.49	12.86
1982	471.44	112.79	358.65	177.95	29.22	53.69	13.06
1983	499.78	122.22	377.57	182.62	27.55	55.47	13.33
1984	524.53	127.51	397.02	191.97	28.76	57.04	13.13
1985	541.39	133.30	408.09	193.75	28.23	55.88	13.44
1986	537.74	136.52	401.22	182.05	25.61	50.01	13.62
1986: I-III	407.49	103.83	303.66	136.81	19.21	37.55	10.18
1987: I-III	421.70	108.88	315.82	138.78	19.52	36.87	10.37

Source: Ministry of International Trade and Industry

Table 11: Household Energy Consumption in Japan

	Electricity (mil kwh)	Propane (bil kcal)	Kerosene (1,000 kl)	LPG (1,000 mt)	Other Solids (1,000 mt)	Coal (1,000 mt)
1980	103,199	56,008	16,725	4,984	1,212.3	578.5
1981	108,979	58,178	16,730	5,336	970.0	472.5
1982	110,051	58,200	15,275	5,295	1,173.0	512.8
1983	117,905	60,748	15,928	5,460	1,010.3	509.2
1984	125,588	66,065	17,130	5,696	1,413.2	469.1
1985	129,682	65,706	16,060	5,611	1,479.3	371.9
1986	134,078	70,124	16,992	5,835	1,222.5	304.0
1986: I-III	101,740	53,762	11,424	4,254	885.0	202.3
1987: I-III	107,777	53,288	10,351	4,090	579.1*	140.8

Source: Ministry of International Trade and Industry

Table 12: Energy Consumption by Industry in Japan
(in kiloliters of crude oil equivalent)

	<u>Metal Mining</u>	<u>Coal Mining</u>	<u>Textiles</u>	<u>Pulp, Paper and Cardboard</u>	<u>Chemicals</u>	<u>Petrochemicals</u>
1983	85,704	663,943	4,023,117	10,480,791	57,216,628	10,671,659
1984	73,995	657,159	4,213,267	10,731,896	66,206,821	10,759,857
1985	73,747	635,692	4,218,646	10,838,465	66,477,596	10,374,103
1986	59,912	624,056	4,342,327	11,093,853	67,046,664	10,065,488
1987	41,522	563,563	4,525,413	11,665,369	69,846,332	10,008,241

	<u>Rubber Products</u>	<u>Nonmetallic Mineral Products</u>	<u>Steel</u>	<u>Nonferrous Ores and Metals</u>	<u>Machinery</u>	<u>Total</u>
1983	421,307	15,482,503	45,462,302	4,375,242	13,676,921	133,909,803
1984	428,331	14,493,878	50,509,329	4,427,235	15,249,193	142,880,126
1985	415,468	13,527,752	50,763,316	4,250,973	15,393,058	141,789,300
1986	415,456	12,502,738	46,778,357	3,905,063	14,321,084	139,389,730
1987	400,364	12,280,545	47,333,105	3,757,101	14,926,466	143,452,025

Source: Ministry of International Trade and Industry

Table 13: Long-Term Energy Outlook, November 16, 1983

(in millions of units and percent share)

	FY 1985		FY 1990		FY 1995		FY 2000	
	Units	Share	Units	Share	Units	Share	Units	Share
Coal (mt)	110.9	19.1%	108.0	17.5%	128.0	18.0%	170.0	20.0%
Nuclear (kw)	24.7	9.5	34.0	10.8	48.0	14.0	62.0	16.0
Natural Gas (kl)	41.3	9.4	56.0	12.1	61.0	12.0	66.0	11.0
Hydroelectric (kw)	34.5	4.9	40.0	5.0	43.5	5.0	48.5	5.0
Geothermal* (kl)	0.5	0.1	1.5	0.3	3.5	1.0	7.0	1.0
Alternatives* (kl)	1.3	0.3	8.0	1.7	19.0	4.0	55.0	9.0
Oil (kl)	249.0	56.7	240.0	52.5	450.0	48.0	260.0	42.0
Total* (kl)	439.0	100.0	460.0	100.0	530.0	100.0	600.0	100.0

*Crude oil equivalent

Source: Ministry of International Trade and Industry

Table 14: Long-Term Energy Outlook, October 14, 1987

(in millions of units and percent share)

	FY 1986		FY 1995		FY 2000		FY 2005	
	Units	Share	Units	Share	Units	Share	Units	Share
Coal (mt)	103.9	18.3%	121.0	18.3%	136.0	18.7%	150.0	19.0%
Nuclear (kw)	25.8	9.5	41.5	13.4	53.5	15.9	65.0	18.0
Natural Gas (kl)	42.8	9.9	55.0	11.1	58.0	10.8	60.0	10.0
LNG (kl)	28.8	6.7	36.0	7.3	38.0	7.1	--	--
Hydroelectric (kw)	35.8	4.2	42.5	4.5	45.5	4.4	48.5	4.0
Geothermal* (kl)	0.4	0.1	2.0	0.4	4.4	0.8	6.0	1.0
Alternatives* (kl)	5.5	1.3	12.5	2.5	24.5	4.5	52.0	9.0
Oil (kl)	246.0	56.8	245.0	49.7	242.0	45.0	240.0	42.0
Domestic (kl)	0.7	0.2	1.3	0.3	1.9	0.4	--	--
LPG (mt)	16.2	--	18.0	--	19.0	--	--	--
Total* (kl)	433.0	100.0	490.0	100.0	540.0	100.0	580.0	100.0

*Crude oil equivalent

Source: Ministry of International Trade and Industry

J A P A N · E C O N O M I C · I N S T I T U T E

J E I

R E P O R T

A Two-Part Report: A and B

NO. 11B
March 18, 1988

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Trade Bill Update

Work on HR 3, the omnibus trade bill, progressed slowly during the first two months of this year, but the last few weeks have seen a quickening of the pace. Several subconferences are working to resolve the differences between the House and Senate versions of the trade package and it appears that the Easter target for floor consideration may be viable.

One reason for the heightened activity is undoubtedly related to the outcome of Super Tuesday's presidential primaries. Richard Gephardt's poor showing has lifted some of the pressure on congressional Democrats to reinforce his tough trade message with protectionist legislation. In fact, some analysts see Mr. Gephardt's loss and the strong victory for free-trader George Bush as a

Progress by the other subconferences has been varied. Some, including the subconference dealing with small business issues, have completed their portions of the bill. Others, most notably the export control subconference, are at an impasse. One of the sticking points for this group is the question of sanctions against Toshiba Corp. and Toshiba Machine Co., Ltd. in response to the subsidiary's illegal sales of sophisticated milling machinery to the Soviet Union.

The Senate proposal includes mandatory two- to five-year sanctions against both firms. The House has suggested that no sanctions be imposed against the parent corporation and that other elements of the provision be softened. A number of senators believe that the House offer amounts to a toothless proposal. Led by Sen. Jake Garn (R, Utah), who has spearheaded the fight for sanctions against both the parent company and Toshiba Machine, the Senate conferees have announced that they are sticking to their original proposal. Similarly, the positions of the two chambers on export controls are poles apart. Although both support the relaxation of unnecessary export control procedures, the House advocates a major liberalization effort; the Senate favors a much more cautious approach.

Whether these are intermediary negotiating positions or signals of more fundamental differences is not clear. Sen. Garn and Rep. Don Bonker (D, Wash.) may meet to try to resolve some of the issues, but tempers have been running high on both sides of Capitol Hill over these questions. Mr. Bonker has expressed concern that if the export control subconference cannot craft a compromise, sanctions and export liberalization may be dropped.

All in all, it appears that the trade bill's prospects are brighter. House Ways and Means international trade subcommittee chairman Sam Gibbons (D, Fla.) remarked March 16 that the bill is "just about on track." He said that Speaker Jim Wright (D, Tex.) is pressuring the subconferences to finish the work so that the House can vote on the compromise package shortly after Easter. If present efforts to work with the administration continue, the trade bill may actually become the Trade Act of 1988.

Eileen M. Doherty

Land Prices Leveling Off

It looks like the rapid run-up in land prices in the Tokyo metropolitan area may be over. A new National Land Agency survey showed that residential land prices in Tokyo dropped 0.8 percent in the last quarter of 1987, after rising 15.5 percent between July and September. In Kanagawa prefecture prices for land rose 1.5 percent, down sharply from the previous quarter's 28.7 percent hike, and in Chiba prefecture, they climbed a slight 1.9 percent against 27.1 percent three months earlier. Because it is a new survey, comparable earlier figures are not available. However, another NLA report put the July 1986-June 1987 residential land price increase in Tokyo at an incredible 94.8 percent, on top of a 30.5 percent jump the year before.

Rising land prices and soaring equity markets have created a vicious cycle: as land prices surged, the collateral available for loans to purchase

securities increased, feeding speculative fever on the stock markets. Higher stock prices in turn provided the collateral for still more land speculation with borrowed money. Some analysts took this argument too far, arguing that a downward spiral of land and stock prices would result from the October stock market crash; instead stock prices have recovered.

Higher land and stock prices have also probably worked to buoy consumer spending, at least by the affluent whose assets increased on paper. But with new uncertainties, first about stock prices in the wake of Black Monday and now land prices, these consumers are likely to be much more cautious.

Nomura Securities Co., Ltd. makes the argument that high land prices divert consumer spending into housing expenditures, reducing funds available for everything else, including imports. Nomura believes this is a major factor behind Japan's trade surplus. Taking both factors into account, it is likely that high land prices have increased consumer spending by the well-off but reduced that of many others.

Most of the effects described are concentrated in Tokyo and a few other large cities. In the rest of the country, land prices have been much more stable. The result has been to increase the already large differential between the cost of land in these cities and the rest of Japan.

Japan's Urban Residential Land Prices

(March 1985=100)

	<u>All Japan</u>	<u>Six Large Cities</u>
September 1980	106.5	110.6
September 1981	117.6	114.8
September 1982	126.4	120.2
September 1983	131.9	124.6
September 1984	136.0	129.6
September 1985	139.2	138.1
September 1986	142.7	165.3
September 1987	156.1	216.1

Source: Japan Real Estate Research Center

The National Land Agency's figures on standard prices for commercial property in prefectural capital cities reinforce the table's data on residential areas. While commercial land prices during 1987 were up nationally 23.8 percent, they jumped in the three most expensive cities by an incredible 40.1 percent in Tokyo, 54.9 percent in Osaka and 91.1 percent in Yokohama. In the three least expensive cities they were up 6.7 percent in Tsu (capital of Mie prefecture), 10 percent in Saga and 12.1 percent in Yamaguchi.

The increase in prices of residential and business properties in Tokyo has focused new attention on that city's land-use practices. High-rise structures and small houses are sometimes almost side-by-side. In Tokyo and other

large cities almost one-sixth of the land is designated as agricultural. Low property taxes and high taxes on profitable sales discourage land sales, making the adjustment to changing demands more difficult.

In an effort to control the land-price spiral, Tokyo has instigated new reporting requirements for real estate transactions, has attempted to control bank lending for speculative purposes and has postponed the sale of public land, among other actions (see JEI Report No. 40B, August 7, 1987, and No. 41B, October 30, 1987). Taxes on land sold within two years of purchase have been increased substantially. Officials attribute the slowdown in price increases to these measures, but their overall impact is unclear. Postponing the sale of public land, for example, could lead to higher prices if it prevents some available property from being converted to new uses.

Douglas Ostrom

EC Tightens Up On "Screwdriver" Plants

The European Community has expressed its displeasure with the quality of Japanese direct investment in continental manufacturing facilities by carrying through on a threat to penalize operations that only assemble imported parts. Such "screwdriver" plants circumvent antidumping controls on particularly sensitive products, the community argued when it adopted legislation last June requiring 60 percent domestic content in all products manufactured by foreign transplants. Japanese businessmen and government officials criticized the decision as potentially harmful to the flow of direct investment in Europe.

According to the EC investigation completed March 8, from 75 to 96 percent of the parts of electronic typewriters assembled by the European subsidiaries of Matsushita Electric Industrial Co., Ltd. (Kyushu Matsushita (UK) Ltd.), Sharp Corp. (Sharp Manufacturing Co.), Canon Inc. (Cannon Bretagne SA) and Silver Seiko Ltd. (Silver Reed International (Europe) Ltd.) are imported. A Japanese electronic scale maker, Tokyo Electric Co., Ltd., has also been charged with exceeding the imported parts ceiling. Two other Japanese electronic typewriter producers, one electronic scale maker and one construction machinery manufacturer were found in compliance with the law. The EC Commission recommended imposing duties ranging from \$27 to \$80 on each of the companies' products, a step that must be approved by a majority of EC members.

The commission took pains to point out that its actions were directed at dumping and not investment. Japanese businessmen were unimpressed, however, commenting that the decision was "regrettable" and "deplorable." The reason so many parts are imported, manufacturers claim, is because local sources for many key parts are not available. This is precisely the point, in the commission's opinion. The EC wishes to attract the high value-added manufacturing that supports assembly operations. With Japan's share of the continental markets for electronic typewriters (approximately 40 percent) and electronic scales (about 25 percent) at stake, Tokyo is investigating whether the EC regulations comply with the rules of the General Agreement on Tariffs and Trade. The community is pushing ahead, however, and has already launched an investigation of Japanese photocopier production under the anti-screwdriver regulations.

On a related matter, Tokyo's 1987 appeal to the European Court in Luxembourg challenging the legality of the anti-screwdriver regulations with regard to electronic typewriters should be decided in the near future. In the meantime, Japanese manufacturers are trying to develop an interim solution, since it would take time to develop local parts production capacity. While the regulations may have the desired short-term effect, they could prove detrimental in the long run.

In other areas, too, Japan's relations with the EC are uncomfortable. Bilateral trade remains the central irritant, and the EC Council is expected to adopt another resolution calling on Japan to liberalize its markets March 22. The Europeans are gratified that Japanese imports from the community rose faster than exports to it in 1987, but they lament the fact that the imbalance is still widening. Continuing the strategy of targeting particular goods, the community will focus on pharmaceuticals, dairy products and intellectual property rights at next summer's bilateral talks.

One theme that the Europeans are sounding will impact on the United States. The EC has long felt slighted by Japanese trade concessions to this country and has recently taken to heavily criticizing U.S.-Japan agreements, most importantly the 1986 bilateral semiconductor agreement (see article in this issue). The Europeans also argue that Japan and the United States give each other special consideration in the areas of telecommunications equipment and financial services. If the EC successfully concludes its case against the semiconductor accord, similar actions in other areas could follow. Although Prime Minister Noboru Takeshita and Foreign Minister Sosuke Uno have pledged to pay more attention to European concerns, it will take some time to do so.

Jon Choy

Japan-EC Trade, 1984-87

(in millions and percentage change)

	Exports				Imports			
	Yen		Dollars		Yen		Dollars	
1984	Y4,597,615	4.5%	\$19,405	4.8%	Y2,210,591	14.6%	\$9,334	14.9%
1985	4,768,004	3.7	20,016	3.1	2,126,894	-3.8	8,893	-4.7
1986	5,173,677	8.5	30,675	53.3	2,348,282	10.4	13,989	57.3
1987	5,490,045	6.1	37,708	12.1	2,552,171	8.7	17,583	25.7

Source: Ministry of Finance

Bilateral Science And Technology Talks Continue: Outlook Unclear

Bilateral negotiations on an agreement governing science and technology cooperation ended March 8 in Tokyo on an inconclusive note. These talks follow up on a January meeting in Washington extending the agreement until the end of March rather than allowing it to expire January 31. Although neither side will elaborate on the sticking points, there are reports that the talks broke down over U.S. demands for tighter controls on technologies with potential military applications and guarantees of intellectual property protection.

increase in total spending compared with the initial FY 1987 plan; a 1.6 percent jump in debt service costs; and a 1.2 percent increase in discretionary spending (see JEI Report No. 13, January 8, 1988). On the revenue side, tax and stamp revenues are projected to rise 9.5 percent, while non-tax revenues and new borrowing will be down significantly, 39 percent and 15.8 percent, respectively. The debt reliance ratio will fall to just 15.6 percent, thanks to expected revenues of ¥1.3 trillion (\$10.4 billion) from the sale of another block of Nippon Telegraph and Telephone Corp. stock.

The upper house is now considering the measure and should vote April 5 to immediately implement the plan. Even if the upper house vote is stymied by continued disagreement between the opposition parties and the Liberal Democratic Party over taxes, the budget will go into effect 30 days after the lower house vote, or April 10.

Car Export Quota - Having made the difficult decision to extend the restraints on Japan's U.S.-bound car shipments for another year (see JEI Report No. 6B, February 12, 1988), the Ministry of International Trade and Industry has decided to leave well enough alone on the allocation of the 2.3 million unit quota among Japan's nine exporters.

Unofficial Quota Allocations, FY 1981-FY 1988

(in units)

<u>Exporter</u>	<u>FY 1981- FY 1983 Quota</u>	<u>FY 1984 Quota</u>	<u>FY 1985- FY 1986 Quota</u>	<u>FY 1987- FY 1988 Quota</u>
Toyota Motor Corp.	516,659	551,792	616,900	613,816
Nissan Motor Co., Ltd.	456,030	487,040	544,500	541,778
Honda Motor Co., Ltd.	348,631	372,338	427,000	424,865
Mazda Motor Corp.	159,282	173,468	227,800	226,661
Mitsubishi Motors Corp. (including sales to Chrysler Corp.)	112,584	122,612	195,100	194,125
Isuzu Motors, Ltd. (including sales to General Motors Corp.)	16,800	49,500	120,400	119,798
Fuji Heavy Industries, Ltd.	70,014	76,250	107,600	107,062
Suzuki Motor Co., Ltd. (for sale to General Motors Corp.)	0	17,000	60,700	60,397
Daihatsu Motor Co., Ltd.	0	0	0	11,498
Total*	1,680,000	1,850,000	2,300,000	2,300,000

*Not included in these figures are the separate quotas on exports of four-wheel-drive vehicles, station wagons and mini vans and on shipments to Puerto Rico. These quotas are estimated at 112,900 units and 95,700 units, respectively, for the FY 1985-FY 1988 period.

The views expressed in this report are those of the authors and do not necessarily represent those of the Japan Economic Institute.

4/1/88

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J A P A N · E C O N O M I C · I N S T I T U T E

JEI

R E P O R T

A Two-Part Report: A and B

NO. 12B
March 25, 1988

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Japan's Economy Up Sharply In 1987

More than a year ago Japan pledged to stimulate its domestic economy as part of an accord worked out at the Louvre to stabilize exchange rates. While the effect of the agreement on the currency markets is debatable, it is clear that Tokyo effectively upheld its end of the pact.

The real growth rate for 1987 was 4.2 percent, evenly distributed throughout the year except for the second quarter when the gross national product was flat. While the rate does not approach the high growth levels of the 1960s and early 1970s, it was still a remarkable feat and a major improvement over the previous years' 2.4 percent. The government's decision to loosen monetary policy and take other measures to stimulate housing increased the pace

Japan's Real Gross National Product at Constant (1980) Prices

(in billions of yen, seasonally adjusted, quarterly totals and rates of growth at annual rates)

	<u>1986</u>		<u>1987</u>		<u>January- March 1987</u>		<u>April-June 1987</u>		<u>July- September 1987</u>		<u>October- December 1987</u>	
Gross National Product	Y298,841.4		Y311,539.9		Y306,780.1		Y306,805.8		Y313,030.0		Y318,374.7	
	(2.4%)		(4.2%)		(6.1%)		(0.0%)		(8.4%)		(7.0%)	
Personal Consumption Spending	167,508.3		173,960.0		171,935.2		173,089.9		174,877.5		175,663.0	
	(3.2%)		(3.9%)		(8.2%)		(2.7%)		(4.2%)		(1.8%)	
Private Residential Construction	15,163.0		18,282.5		16,459.1		16,950.2		18,679.1		21,019.1	
	(8.4%)		(20.6%)		(4.9%)		(12.5%)		(47.5%)		(60.3%)	
Private Fixed Nonresidential Investment	55,607.2		60,198.4		57,949.6		58,973.3		60,554.5		63,033.8	
	(6.1%)		(8.3%)		(10.3%)		(7.3%)		(11.1%)		(17.4%)	
Change in Business Inventories	852.5		718.6		143.9		906.7		716.3		1,095.3	
	(-64.0%)		(-15.7%)		(*)		(*)		(*)		(*)	
Government Current Expenditures	28,771.6		28,615.6		28,384.9		28,726.6		28,648.5		28,709.9	
	(6.5%)		(-0.5%)		(-38.0%)		(4.9%)		(-1.1%)		(0.9%)	
Government Fixed Investment	21,797.8		23,619.8		22,417.9		22,797.4		23,496.0		25,053.8	
	(4.0%)		(8.4%)		(2.8%)		(6.9%)		(12.8%)		(29.3%)	
Change in Government Inventories	797.9		-13.1		226.2		-102.2		-9.2		-164.6	
	(*)		(*)		(*)		(*)		(*)		(*)	
Net External Sector	8,343.1		6,158.0		9,263.3		5,463.9		6,067.3		3,964.4	
	(-33.0%)		(-26.2%)		(113.1%)		(-87.9%)		(52.0%)		(-81.8%)	
Exports of Goods and Services and Factor Income Received	52,397.0		54,221.2		53,451.0		52,466.1		55,981.6		55,045.8	
	(-5.2%)		(3.5%)		(10.4%)		(-7.2%)		(29.6%)		(-6.6%)	
Imports of Goods and Services and Factor Income Paid	44,053.8		48,063.1		44,187.7		47,002.2		49,914.3		51,081.4	
	(2.8%)		(9.1%)		(-2.6%)		(28.0%)		(27.2%)		(9.7%)	

*Cannot be calculated or meaningless.

Source: Economic Planning Agency

of residential construction by 20.6 percent for the year, which by itself added 1 percent to the overall growth rate. Government capital spending added another 0.6 percent.

Plant and equipment investment was the strongest component of private domestic demand. The largest item of all, private consumer spending, managed a 3.9 percent gain for the year, adding 2.1 percent to the overall rate. In the last quarter of 1987, consumption increases slowed while the rest of the economy accelerated; on an annual basis, overall growth was 7 percent, but consumer spending increased at only a 0.4 percent clip.

Framers of the Louvre Accord hoped that Japan's growth would pull in more imports, reducing downward pressure on the dollar and shrinking the trade surplus. Things went just as hoped; coupled with a stronger yen, sharply higher imports more than offset sluggish export growth, and the foreign sector's contribution to economic growth was negative for the second straight year. In the October-December quarter, net exports on a national income basis shrank 34.7 percent from the previous quarter, leaving them at the lowest annual real level since 1982.

The GNP figures also indicate continued good news on inflation. The nominal growth rate was less than the real (inflation-adjusted) growth rate of GNP, because one broad measure of inflation, the GNP deflator, was negative for the first time since 1958, a consequence of the appreciation of the yen and of low oil prices.

If there was any bad news in the report it was that government forecasters had been too pessimistic. As recently as December they were forecasting 3.7 percent real growth for fiscal year 1987, ending this month. If Japan's economy grows 6 percent annually in the first quarter of 1988, a slower rate than the past two quarters, the overall rate for FY 1987 would be 4.5 percent.

The robust economy and the soaring yen contributed to Japan's finishing high in the worldwide per capita GNP sweepstakes, just behind Switzerland and easily surpassing the United States. The figure's usefulness is debatable; measures reflecting living standards and consumer prices still put the United States comfortably ahead of Japan, but the accomplishment is another reminder of the continued strength of the Japanese economy.

Douglas Ostrom

Currency Markets Still Sleeping

In contrast to the turmoil of the holiday season, the currency markets have been remarkably quiet since mid-January. In February the dollar even managed to eke out a small gain against the yen, rising to Y129.15=\$1.00 from Y127.56 in January, the first month-to-month gain since October. On March 18 the dollar closed at Y128.35 on the Tokyo market, having varied barely two yen in the previous two weeks.

Traders have increasingly shrugged off recent U.S. and Japanese trade reports, apparently because they interpreted the numbers as moving in the right direction once seasonal factors were considered. Had the U.S. trade deficit or

Japan. This would eliminate the present requirement for case-by-case approval. Opponents of the pact, who have raised concerns about nuclear proliferation and possible safety hazards, may now attempt to attach conditions to the nuclear agreement. Proponents stress that the pact will insure continued U.S. input on the Japanese nuclear program, as well as drum up millions of dollars worth of uranium sales for this country.

Corrections

In JEI Report No. 11A, March 18, 1988, the rate of operation for 1987 listed in Table 2 should read 71.8 (not 371.8).

In JEI Report No. 11B, March 18, 1988, the base period for the data on Japan's Urban Residential Land Prices was March 1980 (not March 1985).

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The views expressed in this report are those of the authors and do not necessarily represent those of the Japan Economic Institute.

J A P A N · E C O N O M I C · I N S T I T U T E

JEI

R E P O R T

A Two-Part Report: A and B

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GATT Rules On U.S.-Japan Semiconductor Accord

A panel appointed by the General Agreement on Tariffs and Trade has ruled favorably on a European Community complaint that the 1986 U.S.-Japan semiconductor accord violates free-trade rules, although it rejected claims that the pact gave U.S. firms privileged access to the Japanese semiconductor market. The panel did not find the entire pact illegal, as Washington has pointed out, only Tokyo's method of implementing it. The finding, which must be approved by the GATT council, will at best make the task of policing the chip accord more difficult; at worst, it could threaten the use of administrative guidance to support Japan's domestic and foreign economic policy.

forces in the Far East in terms of both quality and quantity and the intensification of related [military exercises] and activities." As in other aspects of bilateral relations, however, U.S. policymakers will watch to see whether these words are actually translated into action.

Barbara Wanner

FY 1988 Tax Reform Proposed In Japan

Attempting to address domestic and foreign concerns, the government's Tax System Council approved a draft fiscal 1988 tax plan March 25. Repeating last year's theme, the proposal focuses on reducing and simplifying individual income taxes. To pay for the reduction and to assure future income, the plan calls for a major indirect tax. Fulfilling a pledge to the European Community, an overhaul of the alcoholic beverage tax system is also outlined. In brief, the plan covers the following areas:

Personal income taxes - The number of brackets will be cut in half to six, with rates ranging from 10 to 50 percent (see Table). Although this change was already slated as part of the FY 1987 tax reform plan (see JEI Report No. 20A, May 22, 1987), the minimum taxable amount will be raised from Y1.2 million (\$9,600 at Y125=\$1.00) to Y2 million (\$16,000). The changes are expected to pare Y3 trillion (\$2.4 billion) from FY 1988 revenues and to keep personal consumption growth strong.

Proposed Personal Income Tax Reforms

(in millions of yen and percent)

<u>Current FY 1987</u>		<u>Proposed FY 1988</u>			
		<u>FY 1987 Plan</u>		<u>FY 1988 Plan</u>	
<u>Income</u>	<u>Rate</u>	<u>Income</u>	<u>Rate</u>	<u>Income</u>	<u>Rate</u>
Y1.5	10.5%	Y1.2	10.0%		
2.0	12.0			Y2.0	10.0%
3.0	16.0				
5.0	20.0	5.0	15.0	5.0	15.0
6.0	25.0				
		7.0	20.0	7.0	20.0
8.0	30.0				
10.0	35.0	10.0	30.0	10.0	30.0
12.0	40.0				
15.0	45.0	15.0	40.0	15.0	40.0
		Above 15.0	50.0	Above 15.0	50.0
30.0	50.0				
50.0	55.0				
Above 50.0	60.0				

Source: Ministry of Finance

Local residence taxes - The number of brackets will be reduced from seven to four and the minimum taxable income will rise from Y600,000 (\$4,800) to Y700,000 (\$5,600).

Corporate income taxes - The rate reductions planned in FY 1987 will be implemented without change. The tax base will be widened, however, by eliminating rules for tax-free reserves and other deductions.

Indirect taxes - The plan calls for a broad tax on goods and services based on one of three models: a value-added tax similar to the European system; a transactions tax; or a general consumption tax. Of the three, the VAT is the leading candidate.

Inheritance tax - The minimum taxable estate would be raised by 50 to 100 percent -- the exact percentage is still to be decided. The current minimum for a surviving spouse with two children is Y32 million (\$256,000). The maximum rate would be cut from 75 percent to 70 percent.

Capital gains tax - A flat tax on capital gains is the leading option at the moment. Opposition parties claim that current rules treating most gains as tax-exempt are unfair to lower income taxpayers. The LDP is afraid that it may derail the market's recovery from October's crash.

Alcoholic beverage taxes - As promised, the ad valorem tax system on distilled liquors, wines and domestic counterparts will be dropped. The classification system for spirits will also be abolished (see JEI Report No. 40B, October 23, 1987).

The problem of compensating for the income tax cuts will be lightened by the April 1 end of the tax-exempt small savings accounts (maruyu). On that date, all interest income will become subject to a 20 percent tax. Even if none of the Y300 trillion (\$2.4 trillion) currently in maruyu accounts is transferred to higher paying instruments, the government can expect to reap Y1.8 trillion (\$1.4 billion) in revenues. Since analysts expect at least some money will seek higher returns, revenues could be even higher.

In the meantime the LDP and the opposition parties continue to wrestle with the final form of the indirect and capital gains taxes. Although the opposition parties have pledged to kill any new major indirect tax, newspaper surveys show that most Japanese are resigned to its introduction. A compromise on a small VAT may be the way out for both sides, since it is not "major" but can be increased in the future if necessary.

Jon Choy

Japanese Firms Increase Capital Spending

Japan's corporate community apparently has been convinced by what the government has been saying for some time: the high yen creates new opportunities. Increased investment by non-manufacturing companies was enough to push up overall plant and equipment spending in 1987, but now even manufacturing

industries are getting into the act. After two years of contraction, plant and equipment spending in the manufacturing sector rose in the October-December period 5.3 percent from the year before.

But it's investment with a difference. According to Ministry of Finance data, those industries particularly well-positioned to profit from expanding domestic demand show the largest increases. For example, steel producers continue to show lower rates of investment than the year before, but the food manufacturing industry is up.

The future apparently will hold more of the same. A survey by the daily Nihon Keizai Shimbun shows that the 1,348 companies questioned expect to increase capital spending by 6.4 percent in fiscal 1988 (April 1, 1988-March 31, 1989), but the plans vary tremendously by industry (see Table). Food manufacturers expect to spend 21 percent more on top of a 35 percent increase this year; steel companies, among the least optimistic, are planning to invest 1 percent less after a 21 percent year-to-year drop in FY 1987.

Japan's Domestic Private Capital Investment*

(in billions of yen and percentage change)

	<u>FY 1987**</u>	<u>1986-87</u>	<u>FY 1988**</u>	<u>1987-88</u>
All industries	¥13,349	1.7%	¥14,208	6.4%
Manufacturing	5,540	-1.9	6,220	12.3
Non-manufacturing	7,809	4.5	7,988	2.3
All industries excluding electric utilities	9,742	3.7	10,632	9.1

*Survey of 1,348 companies.

**Projected figures.

Source: Nihon Keizai Shimbun

Several major exporting industries are increasing spending on new capacity after registering declines last year. The motor vehicle industry, for example, plans a 12.5 percent increase; electrical machinery makers expect a 15.3 percent jump. Some companies with slumping overseas sales find that they still have to invest in new plant and equipment because their existing capacity, though larger than now needed, needs to be kept up-to-date technologically.

Douglas Ostrom

Congressional Trade Concerns Spill Over Into Foreign Policy

Complaints about Japan's trade practices have become standard fare on Capitol Hill. Indeed, they surface in virtually every discussion on trade and other issues affecting the economy. The tendency to single out Japan for complaints -- almost a knee-jerk reaction -- has serious implications for bilateral relations. Perhaps the most obvious consequence of "Japan-bashing" on trade

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J E I

R E P O R T

A Two-Part Report: A and B

NO. 14A

April 8, 1988

JAPAN'S IMPORTS OF MANUFACTURED GOODS

Summary

Japan's imports of manufactured goods, while increasing dramatically in 1986 and 1987, are still relatively small. Yet the latest jump comes on top of a steady increase that has been going on for years: between 1973 and 1987 the volume of manufactured imports rose two-and-a-half times. Manufactures as a share of all imports also increased during this period, reaching 44 percent last year.

The role of American exports to Japan has also been changing. For example, shipments of electric and nonelectric machinery and transportation equipment from the United States were rising even before the yen began its rapid ascent. In 1987 more than half of all U.S. goods sold in Japan were manufactured products, belying the image of the United States as primarily a supplier of industrial and agricultural raw materials. Even so, American policymakers and others looking at Japan's manufactured imports even in 1987 concluded that while barriers -- whether the creation of government or a result of business practices -- were lower than earlier, they are still at least partly responsible for keeping U.S. products out.

Eventually further changes could silence Japan's critics, but not so far. While manufactured imports in Japan are up, they are still lower than in comparable countries. While barriers are down, they remain a factor. The rapid increases in imports in 1986 and 1987 have not persuaded those who a few years ago saw lack of access as a problem.

Others see the situation completely differently. In their view import barriers have not been a serious problem since the late 1970s, if then. These experts admit that barriers exist, but deny their importance in explaining Japan's trade; other factors, such as resource endowments, are seen as the key. This study looks at how restrictions on access compare with competing reasons in explaining Japan's import pattern.

The Importance of Manufactured Goods

As a percentage of Japan's total imports, manufactured goods are remarkably low compared to other industrial countries (see Table 1). While the data in this and other tables refer to 1985, and imports of manufactured goods rose dramatically in Japan in 1986 and 1987, the huge discrepancies in 1985 suggest that the differences between Japan and the other countries, while no doubt smaller in 1987, remain substantial. In one sense it is hardly surprising that Japan's manufactured imports are so low, since its manufactured exports are very competitive in other countries despite the considerable difficulties of operating internationally.

Table 1: Manufactured Goods as Percent of Total Imports

	<u>Japan</u>	<u>United States</u>	<u>Canada</u>	<u>European Community*</u>	<u>EFTA*</u>
1982	20.2%	57.7%	75.0%	41.7%	66.2%
1983	22.2	61.2	78.9	55.9	67.6
1984	24.2	66.4	80.0	56.5	68.0
1985	25.3	70.1	81.7	58.1	69.7

*The European Community includes Belgium, Denmark, the Federal Republic of Germany, France, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain and the United Kingdom. EFTA, the European Free Trade Association, includes Austria, Finland, Iceland, Norway, Sweden and Switzerland.

Note: The figures in this table and the graph are not comparable because of differing category classifications.

Source: Calculated from United Nations Statistical Office, Comtrade database.

Consider, for instance, the impact of transportation costs on a product of uniform quality and subject to no or very low tariffs. Since average U.S. costs cannot be lower than those in Japan when the difference in transportation costs is taken into account (a condition for exports to Japan) and simultaneously be higher (a condition for imports from Japan), Americans will either export or import an item from Japan, but not both. If we know the Japanese export a product, then we should not expect them to import it. More generally,

if Japanese manufactures are highly competitive abroad, we should expect their manufactured imports to be low.

Yet other countries do plenty of this kind of trade. Even countries that export large amounts of a product generally import it as well. Thus while Sweden exports its Volvos and Saabs around the world, it also imports cars from Britain, Germany and elsewhere. Japan, by contrast, is among the world's powerhouses in terms of motor vehicle exports, selling over 2 million cars in the U.S. market alone annually and about 3 million in other export markets, but it imports only about 100,000 cars each year from abroad.

Measuring Intra-Industry Trade - Table 2 gives one measure of the extent to which countries export and import the same item, a phenomenon called intra-industry trade. The index ranges in value from -1 for those countries that only import the good to 1 for those that only export. A value of zero indicates that the country exports and imports a product in equal amounts. Positive or negative values close to zero indicate extensive intra-industry trade. In the case of the European Community two figures are given: one for all trade crossing national boundaries and one that excludes intra-community trade. For the European countries, intra-industry trade is more likely for reasons of geography alone. The external trade figure offers a more meaningful comparison with nations far from other industrial countries such as Japan, or continental countries like Canada and the United States.

The figures show that Japan generally has much less intra-industry trade than the other countries. Canada has the most, hardly surprising considering that much of the Canadian manufacturing base is located close to the United States. Even the European Community's trade with the rest of the world (which includes some non-member European countries) includes more intra-industry trade than Japan's. Notice, though, that there are important exceptions: Japan has more intra-industry trade in chemicals than any of the others and it is in the middle range in textiles, ahead of Canada but behind the United States.

Manufactured imports have been rising in Japan for some time, although there is considerable year-to-year variation both overall and in particular categories (see Table 3). In 1986 and 1987 the increases were particularly rapid. As a percentage of all Japanese imports, manufactured goods have shown the same substantial annual fluctuation, but are clearly rising over the long term (see Graph). While in the late 1960s manufactured goods accounted for under a quarter of all imports, in 1987 the ratio hit 44 percent. In February 1988 it was a record-high 49 percent.

The graph clearly shows the effect of the two oil shocks. During both the price of crude oil jumped and demand for dollars to pay for the oil soared. Accordingly, the value of the dollar rose and the yen weakened. The new exchange rate tended to raise the price of all imports; demand for manufactured goods was especially price-sensitive. The graph demonstrates the result: the oil shocks reduced manufactured imports relative to other imports. In fact, it appears that each of the oil shocks was enough to reverse for a time the upward trend in the share of manufactured imports.

Table 2: Major Industrial Countries' Indices of Intra-Industry Trade, 1985

	<u>Japan</u>	<u>United States</u>	<u>Canada</u>	<u>European Community</u> <u>Overall</u>	<u>External</u>
Steel	0.80	-0.80	0.06	0.19	0.46
Chemicals	0.04	0.14	-0.08	0.13	0.34
Other					
Semimanufactures	0.24	-0.48	0.46	-0.02	-0.02
Specialized Industrial					
Machinery	0.78	-0.02	-0.40	0.28	0.52
Office and					
Telecommunications					
Equipment	0.72	-0.04	-0.30	-0.06	-0.18
Motor Vehicles	0.96	-0.50	0.04	0.18	0.42
Other Machinery					
and Transportation					
Equipment	0.64	0.08	-0.28	0.15	0.26
Household					
Appliances	0.94	-0.76	-0.38	-0.11	-0.20
Textiles	0.44	-0.36	-0.66	0.05	0.10
Clothing	-0.46	-0.9	-0.68	-0.09	-0.22
Other Consumer					
Goods	0.38	-0.64	-0.44	0.13	0.26
Total					
Manufactures	0.68	-0.28	-0.10	0.11	0.24

Note: The index is $(\text{exports} - \text{imports}) / (\text{exports} + \text{imports})$.

Source: Calculated from United Nations Statistical Office, Comtrade database.



Source: Ministry of Finance

Table 3: Quantum Indices of Japan's Manufactured Imports, 1973-87

(1980=100)

	All manu- factured Imports	Chemicals	Non- electric Machinery	Electric Machinery	Transport Equipment	Precision Instru- ments	Miscellaneous Manufactured Goods
1973	75.9	67.7	*	*	*	*	108.8
1974	81.7	84.1	*	*	*	*	85.7
1975	61.2	42.1	*	*	*	*	68.6
1976	69.7	56.3	*	*	*	*	77.3
1977	70.7	62.3	*	*	*	*	76.9
1978	86.6	75.7	*	*	*	*	98.1
1979	102.6	97.8	*	*	*	*	111.5
1980	100.0	100.0	100.0	100.0	100.0	100.0	100.0
1981	112.5	103.6	90.6	115.3	103.2	95.7	123.0
1982	113.3	113.1	90.8	116.2	51.6	92.0	130.1
1983	116.1	124.1	83.2	120.2	80.5	102.1	127.7
1984	139.6	141.4	100.6	158.4	81.7	135.4	155.1
1985	142.1	144.0	108.1	149.1	82.0	147.1	159.4
1986	176.8	151.8	109.8	154.9	110.9	141.8	224.9
1987	193.0	169.5	125.1	200.0	117.1	184.7	237.4

* Not available.

Note: Imports are c.i.f.

Source: Ministry of Finance

The trend toward more foreign-made manufactures has several aspects. Within most broad product categories, higher value-added goods are being purchased from abroad (see Table 4). Steel and other metal manufactures, for example, increased from about one-third to more than one-half of all ores and metals imports between 1973 and 1984.

Table 4: Shifts in Japan's Import Structure

Product Group	1984 Import Value (in billions of dollars)	Share of Processed and Manufactured Goods in Sectoral Imports		
		1973	1979	1983-84
Food	\$13.9*			
Processed Food	2.8	22%	21%	20%*
Wood	6.7			
Processed	1.9	15	20	28
Manufactured	1.7	16	13	25
Ores and Metal	13.7			
Manufactures	7.1	34	41	51
Fibers, Textiles & Clothing	6.4			
Textiles	1.9	29	32	30
Clothing	1.9	15	29	30
Petroleum	45.5			
Petroleum Products	6.1	11	12	13

*Data refer to 1983.

Source: General Agreement on Tariffs and Trade, International Trade 1984/85, Appendix Table A-29 using data from Japan Tariff Association, The Summary Report: Trade of Japan, and United Nations, Yearbook of International Trade Statistics.

Intra-industry trade is up as well. In many cases the imports come from newly industrializing countries such as South Korea and Taiwan. Color television sets, for example, have long been a symbol of Japanese export success. But in 1987 Japanese exports slid 18 percent to 3.8 million units, while imports from South Korea, Taiwan, Hong Kong and Singapore soared from 21,493 to 347,471, an increase of 1,500 percent. In other words, Japan took only one year to develop significant intra-industry trade in color televisions. In steel the same pattern is evident: imports increased about 40 percent in 1987 while exports declined slightly. Imports of steel are now one-sixth the volume of exports. Table 5 shows Japan's imports of some important categories of manufactured goods in the 1985-87 period.

Unfortunately, U.S. exporters have not fully shared in this import boom, despite the dollar's drop against the yen and the currencies of most of its rivals in Europe and Asia. In the first half of 1987, the dollar value of Japanese manufactured imports from the United States was up 16.1 percent, compared to a jump of 44.1 percent for the European Community and a whopping 66 percent increase for the Asian industrializing countries. The percentage increase for the United States would have been somewhat higher in 1987 without the one-time shipment of gold to Japan in 1986.

Table 5: Japan's Imports of Selected Manufactured Goods, 1985-87

(in millions of dollars)

	<u>1985</u>	<u>1986</u>	<u>1987</u>
Chemicals	\$8,073	\$9,733	\$11,845
Office Machinery	1,545	1,706	2,218
Power Generating Machinery	896	897	1,136
Metalworking Machinery	234	295	277
Textile Machinery	113	134	216
Aircraft	1,484	1,777	1,742
Ships	286	231	269
Precision Instruments	1,265	1,416	1,860
Steel Products	1,480	1,762	2,484
Textiles, Including Clothing	3,886	5,027	7,624
Nonferrous Metals	4,041	3,655	5,644
Toys and Indoor Games	98	176	391

Source: Ministry of Finance

The future growth of manufactured imports in Japan will depend partly on whether the prices of Japanese imports fall in line with currency appreciations. The Bank of Japan's import price indexes have declined significantly as the yen has risen. Chemicals, for example, dropped 27.8 percent in 1986 and another 10.5 percent in 1987. Machinery and transportation equipment fell 21.9 percent in 1986 and 8.5 percent in 1987. While these drops do not match that of the dollar they should not be expected to because they reflect in part the influence of currencies that declined against the yen less than the dollar.

Marketing and Distribution - Imported consumer goods generally pass through the Japanese distribution system which, some importers complain, absorbs the price cuts by increasing its own margins, leaving the retail price unchanged. Even if this is true, import sales could still increase if the higher margins led distributors and retailers to greater promotional efforts.

A Ministry of International Trade and Industry study of retail pricing suggests, however, that at least some of the price cuts are getting through to the consumer, although not necessarily the full reduction. Of 82 imported brandname goods it looked at in January 1988, 35 were priced below their August 1985 levels -- before the dollar started falling; of the 35, 28 were selling at lower retail prices as well. The 47 products whose import prices did not fall were all from Europe, where currencies were more stable against the yen. In short, MITI's report lends credence to the belief that exports from countries with depreciating currencies will end up with lower consumer prices in Japan.

Increasing numbers of retailers and even individuals are attempting to bypass the distribution network by importing directly. Especially prominent are superstore chains, such as Daiei, Inc. and Jusco Co., Ltd., which are even investing in overseas manufacturing facilities. Morgan Stanley and Co. estimates that direct imports accounted for 7.2 percent of total sales at Jusco last year.

This pattern is likely to get another boost as Japanese manufacturing firms increase domestic sales of goods produced by their overseas subsidiaries. They will be following in the well-worn footsteps of U.S. firms. Honda Motor Co., Ltd. is beginning to sell Ohio-made cars in Japan, but Ford Motor Co. has been selling cars made at its plants in Europe in the United States for most of the postwar period. In 1982, 14.6 percent of U.S. imports were from overseas subsidiaries of American firms; the comparable figure in Japan (but for 1983) was only 3.7 percent; the number now is undoubtedly higher but still well below the U.S. level.

Why Japan Imports So Few Manufactured Goods: Some Competing Explanations

Over the years many factors have been cited as contributing to the low share of manufactured goods in Japan's import mix. Some stress cultural influences, others political or economic determinants.

- Compared to countries such as the United States, which have both abundant natural resources, including agricultural land, and the ability to make manufactured goods, Japan has virtually nothing to offer in international commerce except manufactured goods. By necessity a large fraction of its trade will be exports of manufactured products in exchange for imports of industrial and agricultural raw materials. Of course, over time Japan's relative ability to produce manufactured products has changed as, for example, its labor force has become more educated. Those countries with a more complex resource endowment will have more complicated trading patterns.

- Japan continues to maintain barriers against imports, particularly on manufactured goods. Obviously, if the barriers are high, imports are low. Less obviously, so are exports. Consider what happens to the exchange rate when barriers exist. The demand for foreign currency to pay for imports declines, leading to a drop in its value relative to the yen, assuming no offsetting changes such as increased capital flows into the United States. The more expensive yen in turn reduces exports. Even if net exports end up unchanged, with both exports and imports lower, intra-industry trade will probably be less.

Barriers need not be government-imposed. Governments in Japan and elsewhere control the level of tariffs and quotas on manufactured products, but have persuasive power, at best, over business practices such as tight delivery schedules that could be effective in excluding foreign producers. Some barriers such as quotas are absolute, establishing effective ceilings that keep out particular imports regardless of price competitiveness. Others, including tariffs and many business practices, may be price sensitive, and ineffective in the face of a sufficiently large advantage in buying from outside Japan.

- Other countries have barriers against Japanese products. This argument is really the same as the previous one. If Japan is restricted in selling products abroad, its currency will depreciate as the ability of its exporters to earn and then exchange other currencies for yen diminishes. Import prices of goods shipped into Japan will then be higher and imports will decline.

- Macroeconomic policy is out of whack. When the United States has a large budget deficit and Japan a high savings rate, a slight rise in U.S. interest rates will attract Japanese investors, whose money is required to finance the deficit. Japan's demand for dollars increases the dollar's value,

raising the price of exports to Japan. If manufactured goods are more sensitive to price changes than raw materials, their percentage of imports will decline, as will the ratio of Japanese imports to exports.

- Japan has different tastes. Intra-industry trade is more likely if tastes are similar across countries and varied within each country. For example, trade in cars occurs partly because some Swedish drivers have a preference for Peugeots and some French consumers like Volvos. The Japanese have until recently been comparatively united behind one type of car, and domestic makers have produced it efficiently, making imports virtually unnecessary. While affluent Japanese are increasing their purchases of Mercedes and other expensive European imports, significant intra-industry trade in cars is still years away.

- Japan is uniquely geographically isolated among the industrial countries, leading to higher transportation costs and slower deliveries. Exports are more expensive in foreign markets and importers have a harder time selling profitably in Japan, reducing trade in both directions.

Evidence

Policymakers have an obvious interest in knowing which of these arguments is correct. If the Japanese government maintains high import barriers, the excluded American producers obviously lose out and Washington can do U.S. producers and Japanese consumers a big favor by getting Tokyo to reduce or eliminate the barriers. If some Japanese firms refuse to import intermediate goods because they value the long-term relationships with their existing domestic suppliers, Tokyo can try to persuade the firms to change their business practices. If the U.S. budget deficit is to blame, there is little U.S. negotiators can properly ask the Japanese to do, and Washington should redouble its own efforts to reduce the deficit. Most discouragingly, some explanations suggest there is little anyone can do: for example, the Japanese cannot alter geography, being stuck across an ocean or continent from other major industrial countries.

Economists are in the midst of a lively debate as to the relative merits of the different arguments. Japanese barriers of various kinds have received extensive treatment. (See JEI Report No. 28A, July 24, 1987, for a discussion of the Japanese distribution system.)¹ Merely finding a barrier is not the same as assessing its impact. As noted earlier import barriers can work through the exchange rate to reduce exports as well as imports. Moreover, they may or may not be set at levels that carry any impact. The quota on Japanese car exports to the United States may no longer be keeping any cars out of this market, given the recent strength of the yen, which would have reduced imports regardless.

¹ For a list of other references see Robert Z. Lawrence, "Imports in Japan: Closed Markets or Minds?," Brookings Papers on Economic Activity, 1987:2, p. 517-18. For a discussion that emphasizes business practices as barriers to imports, see Daniel I. Okimoto, "Outsider Trading: Coping With Japanese Industrial Organization," in Kenneth P. Pyle, editor, The Trade Crisis: How Will Japan Respond?, Society for Japanese Studies, 1987, pp. 85-116.

To actually assess the impact of one factor or another economists have turned to more sophisticated methods. The general idea is to statistically estimate the factors that influence Japan's trade and then see how much is left to be explained by a "Japan (or other country) policy factor."

Gary R. Saxonhouse of the University of Michigan is a pioneer in this work. He begins by considering the view, almost universally held by the economics profession, that international trade is -- unless policymakers intervene -- a consequence of each country's supply of labor, capital stock, natural resources and intermediate goods. For example, those countries with large populations but little else are expected to produce and export products using their abundant labor. Their imports will be those goods using relatively little labor compared to other inputs. Saxonhouse econometrically asks whether this approach adequately explains Japanese trade or if factors that reflect policy choices are needed.

His answer, according to a paper presented to the American Economics Association in December 1987, is that factor endowments do indeed explain trade patterns and there is no obvious need to include Japanese trade policies as a factor. As Saxonhouse puts it, ". . . this suggests that whatever Japanese (and American) trade policies (and/or informal barriers) may have been, more than likely they have not been a major determinant of trade patterns."²

Saxonhouse's conclusions hold even without the inclusion of transportation costs as a factor, the measurement of which has been a contentious issue among those studying the question. Even more importantly, his newest work describes gross imports and exports. In his earlier work, he worked with net exports, which left open the possibility that Japan's barriers had the effect of reducing both exports and imports, leaving net exports little changed but with significant effect on unfortunate American and other would-be exporters to Japan.

Based on Saxonhouse's earlier work, Robert Z. Lawrence of the Brookings Institution argued the need to look at intra-industry trade, which Japan's policies and business practices could be affecting. His econometric work on gross imports appeared to demonstrate that in fact there was a "Japan factor": that Japan's manufactured imports were significantly lower than could be explained by objective factors such as transportation costs, leading him to conclude:

[I]n 1980, for example, as equations in this study indicate, unusual barriers and preferences reduced Japanese manufactured goods imports about 40 percent. The removal of such barriers would have increased the value of Japanese manufactured imports about \$13 billion and lowered Japan's trade surplus in manufactured goods about \$16 billion, or some 17 percent. Japan would have considerably more intra-industry trade.³

²Gary R. Saxonhouse, "Differentiated Products, Economies of Scale and Access to the Japanese Market." (paper presented to the American Economics Association, December 1987), p. 26.

³Lawrence, p. 546.

Even Lawrence's conclusion offers less reassurance than it appears to American manufacturing firms hoping that removing Japanese barriers would improve their prospects. His procedure leaves open the possibility that some of the barriers could be American. These, as explained earlier, reduce exports from Japan that in turn affect the exchange rate and end up reducing imports to Japan as well. Lawrence argues, however, that most of the barriers are Japanese. What his data show is that Japan's trade is different. Some of these differences could be deeply rooted in the culture and thus impossible to change. Not necessarily parochial, they could reflect a homogeneity of taste that is the result of narrow social and economic differences in modern Japan. In any event, he concludes that removal of Japan's barriers would increase both Japanese imports and exports, which is not exactly what beleaguered U.S. firms, already fighting what they see as a flood of Japanese imports, want to hear.

At this writing the controversy continues. Lawrence's and Saxonhouse's work will certainly not be the last. Policymakers should stay tuned; the questions go to the heart of the many trade controversies between the United States and Japan.

The Political Dimension

Japan's low level of imports -- especially of manufactured goods -- has become a political issue. The view that the Japanese market is relatively closed may well influence feelings about Japan generally; a sense that the Japanese do not play fairly is of course widespread. Tokyo argues that this is a misperception and would like to see it changed.

Lawrence says that the lack of intra-industry trade between the United States and Japan creates a political problem: relatively few U.S. firms benefit from exports to Japan, so few speak up for Japan politically. Even if reduced Japanese barriers also lead to more exports to the United States, at least the increased U.S. shipments to Japan would create a countervailing political force in the American business community that could ward off some of the more nefarious protectionist political pressures.

The problem for Japan could be that there is considerable truth in both the Saxonhouse and Lawrence arguments -- Saxonhouse in minimizing the economic role of Japanese barriers and Lawrence in seeing the political usefulness of more manufactured goods trade. If so, Tokyo could reduce its remaining governmental barriers and manufactured goods imports would remain about the same: the relative supply of productive inputs would determine trade, meaning American manufacturers would gain little in the Japanese market and Japan would gain nothing in political clout. In this case Japan would be condemned by its natural endowments to continuing political problems in Washington.

Even if Japan does not gain political allies, economists and political scientists generally feel that it would reap political dividends by reducing trade barriers; it would be harder to find evidence that Tokyo is skewing trade to its benefit.

Conclusion

The controversy over manufactured imports is part of a broader disagreement about the role of the Japanese government in the economy. If, as the Japanese argue, the role is relatively minor, there is little that Americans can reasonably ask Tokyo to do to reduce trade tensions. If business practices, for example, are the problem, the government's function is at most to persuade firms through administrative guidance. On the other hand, if there are important barriers that Tokyo could remove on its own, a significantly different pattern of trade between the two countries could emerge from negotiations. For both countries that would mean both new opportunities and new vulnerabilities.

For further information, contact Douglas Ostrom.

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The views expressed in this report are those of the author and do not necessarily represent those of the Japan Economic Institute.

4/19/88

R5650-2

J A P A N · E C O N O M I C · I N S T I T U T E

J E I

R E P O R T

A Two-Part Report: A and B

NO. 15B
April 15, 1988

U.S. Makers Of Small Pickups
Say Japanese Rivals Dumping 1

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Cocom Violators 4

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U.S. Makers Of Small Pickups Say Japanese Rivals Dumping

A year after U.S. automotive industry executives went public with their complaints about the pricing of Japanese compact pickup trucks in the American market, the Big Three has still not filed an antidumping petition with the government. Instead, it has hit on a unique strategy -- asking the Reagan administration to "consult" with Tokyo in an effort to stop the alleged dumping. This call, contained in a March 29 letter from the Motor Vehicle Manufacturers Association to Commerce Secretary C. William Verity, was accompanied by a study of Japanese pricing commissioned by the automotive trade group. The report claimed that all five Japanese makers that market small pickups in the United States -- Toyota Motor Corp., Nissan Motor Co., Ltd., Mazda Motor Corp., Isuzu Motors Ltd. and Mitsubishi Motors Corp. -- are selling vehicles here for less than at home. Their alleged dumping margins ran from 10.9 percent to 46.9 percent.

At first glance it is difficult to understand why General Motors Corp., Ford Motor Co. and Chrysler Corp. have not gone the trade-complaint route when they have such presumably hard evidence of sales at less than fair value. MVMA officials lamely say that the pricing study was undertaken as a follow-up to several rounds of discussions between Big Three representatives and the Commerce Department, which has been looking into the possibility that Japanese exporters of trucks and a number of other products are dumping since their U.S. prices have not gone up by the full extent of the dollar's drop against the yen (see JEI Report No. 38B, October 9, 1987, and No. 10A, March 11, 1988).

Far from being a mystery, Detroit's strategy of trying to enlist the White House to run interference is a creative solution to a very basic problem. Even if an antidumping petition were filed and Commerce found less-than-fair-value sales by one or more Japanese makers of compact trucks, domestic producers would have an impossible job proving that they have been hurt, the second phase of any dumping proceeding. Sales of U.S. compact pickup nameplates set another record in 1987, jumping 18.5 percent to 782,000 vehicles, while the American import arms of Japanese manufacturers struggled to sell 623,000 small pickups, 19.5 percent fewer than 1986's total (see Table). Moreover, sales of the U.S. industry's downsized vans and sports-utility vehicles continued to break records last year, another reason the Big Three's profits of \$9.5 billion were just shy of 1984's all-time high.

Anticipating that the injury question would be the Achilles' heel of any antidumping complaint, the Washington law firm that prepared the MVMA study tried to build a case for lost production and profits. In this scenario GM, Ford and Chrysler could have produced an extra 140,000 compact pickups in 1987 if "dumping had not driven sales of imported trucks." The output lost was claimed to have cost the three makers \$130 million in earnings and industry workers \$140 million in wages and benefits. It also cost jobs, in Detroit's version of events, since manufacturers might have converted car plants that are being shut down to truck production if the return on small pickup sales had not been depressed.

Trade lawyers also speculate that the failure of GM's and Ford's Canadian subsidiaries to prove last month that dumping by Hyundai Auto Canada Inc. had hurt their car production plays a part in Detroit's decision to hold off filing a complaint against Japanese exporters of compact pickups. But another factor is undoubtedly at work as well. Companies that charge dumping cannot target specific competitors in an industry and in going after Toyota and Nissan, the Big Three would also hit their own affiliates -- Isuzu (GM), Mazda (Ford) and Mitsubishi (Chrysler).

Spokesmen for Japan's motor vehicle makers have repeatedly denied that the companies are selling compact pickups in the United States for less than in Japan, but neither they nor corporate representatives of other big exporting industries are taking Detroit's maneuvering lightly. The Big Three do not rule out filing an antidumping petition if the current strategy fails. That could open the floodgates for other formal complaints, starting with cars.

Susan MacKnight

U.S. Retail Sales of Light-Duty Trucks, 1986-87

(in units)

<u>Nameplate</u>	<u>1986</u>	<u>1987</u>
Compact Pickups	1,434,662	1,405,297
Toyota	320,702	252,946
Nissan	216,505	164,528
Mazda	157,127	123,699
Isuzu	51,827	44,297
Mitsubishi	28,307	37,835
Japanese Nameplates	774,468	623,305
Ford	269,490	305,295
Chevrolet	203,416	224,807
Dodge	107,751	164,638
GMC	46,084	49,191
Jeep	33,453	38,061
American Nameplates	660,194	781,992
Compact Vans	603,085	687,617
Toyota	33,290	19,414
Nissan	0	17,673
Mitsubishi	2	3,103
Japanese Nameplates	33,292	40,190
Ford	150,049	159,149
Chevrolet	147,932	148,205
Dodge/Plymouth	240,634	307,841
GMC	31,178	32,232
American Nameplates	569,793	647,427
Compact Sports-Utility	594,429	689,298
Toyota	30,158	31,423
Nissan	6,901	34,313
Isuzu	36,893	42,693
Mitsubishi	6,676	10,924
Suzuki	47,732	81,349
Subaru	4,142	1,274
Japanese Nameplates	132,502	201,976
Ford	103,020	120,905
Chevrolet	159,820	153,064
Dodge	4,768	19,539
GMC	39,027	38,841
Jeep	155,292	154,973
American Nameplates	461,927	487,322
Conventional Pickups	1,237,500	1,204,232
Conventional Vans	512,823	473,396
Conventional Sports-Utility	222,338	208,643
Total Light-Duty Trucks	4,604,837	4,668,483
Share of Japanese Nameplates		
Compact Pickups	54.0%	44.4%
Compact Vans	5.5%	5.8%
Compact Sports-Utility	22.3%	29.3%
Total Compact Trucks	35.7%	31.1%
Total Light-Duty Trucks	20.4%	18.5%

Source: Automotive News

4/27/88

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J A P A N · E C O N O M I C · I N S T I T U T E

JEI

R E P O R T

A Two-Part Report: A and B

NO. 16A

April 22, 1988

THE CHANGING PATTERN OF JAPANESE TRADE: AN OVERVIEW

Summary

Japan has increasingly oriented its trade toward other industrial countries over the past 20 years, particularly the United States. At the same time, China's economic reforms and the rise of the "Four Dragons" -- South Korea, Hong Kong, Taiwan and Singapore -- have expanded Japan's trade in the Pacific Basin, increasing its central role in the nation's trade picture. The obverse of these developments has been a contraction of trade with other regions, particularly Africa and Latin America -- areas that would benefit immensely from greater participation in global trade. The changing pattern of Japanese trade presents Tokyo with opportunities as well as problems as it searches for a new position in a shifting global order.

The Inevitability of Change

With the expansion of the Japanese economy over the past two decades, it is not surprising that its trade pattern has also changed. As the focus of economic activity has shifted from basic industry to manufactures of steadily increasing sophistication, the inputs demanded and products exported have followed suit. The role of energy imports, for example, has steadily declined as the economy moved away from energy-intensive basic industries, while imports of basic and intermediate industrial products have grown precisely because of this shift.

Just as Japan has changed so have the import needs and export offerings of other countries. The focus on consumption in post-industrial Europe and the United States has provided an insatiable market for Japanese consumer products. Since these areas represent a large part of global economic activity, it is not

surprising that they have attracted an increased share of Japan's exports. The rapid development of several third-world nations (Brazil, South Korea, Taiwan, Singapore and India) has been fed in part by Japanese exports of capital equipment and intermediate goods, but it has not been enough to balance the appetite the developed countries have acquired for Japanese products. The atrophy of economic development in Africa and the debt crisis in Latin America are also reflected in Japan's trade pattern, which shows a decreasing share of both imports from and exports to these areas.

In some cases, global economic changes have led to a significant rearrangement of Japan's trade activities. The sharp boost in crude oil prices by the Organization of Petroleum Exporting Countries in the early 1970s tripled Japan's imports from the Middle East between 1973 and 1974, and they doubled again between 1978 and 1979. This pattern persisted until recently when falling crude oil prices, amplified by the declining yen cost of dollar-denominated oil contracts, cut purchases.

Economic developments do not have a monopoly on influence, however. Of the political changes that have had a clear impact on Japan's trade, one stands out: the ascendance of progressive leaders in Beijing. Abrupt changes in China's economic development plans turned the gentle flow of Sino-Japanese trade into a torrent in 1985. Political pressures similarly led to a reduction in trade in the following two years as Beijing tried to stem the resulting drain on its foreign reserves.

The fact that Japan's pattern of trade has changed over the past 20 years is therefore unremarkable. What is instructive is exactly how it has changed and what recent shifts indicate for the future.

The Shifting Pattern of Trade, 1966-87

From the available data one basic rule driving Japan's export trade pattern emerges: exports are sensitive to market growth for specific products. Geographic location, relative overall economic growth abroad, and global factors such as changes in exchange rates and commodity prices have less influence on the value of exports than might be expected. While at first glance this seems to be only common sense, it reflects the importance of exports to Japan and the consequent development of export expertise. Japan's major role, if not dominance, of global trade in particular products, including cars, consumer and industrial electronics and certain production equipment, testifies to its skill as an exporter.

Imports, on the other hand, seem to have been increasingly influenced by geography over the past two decades. Japan's purchases from Pacific Basin nations and Asian countries in particular as a share of total imports have steadily risen. Underpinning this trend is the emergence of a number of Asian countries as low-cost suppliers of an increasing range of basic manufactures. Equally important has been the resource endowment of countries along the Pacific Rim. Efforts to promote imports from the United States and market liberalization programs may also have contributed to this trend, although it

may be enhanced by the yen's sharp appreciation against currencies of both the developing and the industrial nations.

Regional trade - Figures 1-3 show that Japan's regional trade is dominated by Asia -- particularly in the case of imports -- reflecting the relatively underdeveloped consumer markets in Asia versus their emphasis on exports of agricultural and industrial raw materials and light manufactures. It is interesting to note that Asia's share of total imports rose sharply in the mid-1970s to the early 1980s, a time when the yen was relatively weak against the dollar and therefore against most Asian currencies, which are pegged to the greenback.

The role of the United States as a market for Japanese exports is quite clear. North America's share of Japan's overseas shipments grew strongly after 1980, and particularly after 1983 when the United States came out of recession. Whether the dollar's depreciation will reverse this trend is uncertain, although North America's export share does seem to have leveled off.

After years of little change, Japan's trade with Europe appears to be taking on greater significance, thanks mostly to rising imports. The continent's small share of total trade in comparison with North America and Asia helps explain the relatively limited amount of attention Tokyo has given to European concerns.

Perhaps the most striking aspect of the shifting regional trade pattern is the decline in Japan's trade with Africa and Latin America. While imports from the two regions as a share of total trade have remained stable, their importance as export markets has dwindled to almost nothing. Since the Latin American debt crisis and African economic problems are not new factors, the decline must be due to the relative growth of exports to other areas.

Trade by bloc - The differing roles of the industrial and developing countries is evident in Figures 4-6. North America, Western Europe, Australia, New Zealand and South Africa currently buy 60 percent-plus of Japan's exports, while the developing nations (all the other non-communist countries) sell Japan anywhere between 45 and 55 percent of its imports. While this pattern is to be expected since the developed nations are wealthier, the rising shares of both exports and imports by the developed countries is worth noting.

The constant trade shares of the communist nations reflect the political and economic difficulties of East-West trade. While this trade component has not grown relative to Japan's other two major trading groups, it has participated in the 20-fold increase in Japanese trade over the past 21 years. As seen in the country data, the hefty increase in Japan's trade with China has been primarily responsible for the communist bloc's steady share.

Trade by product group - The increasing sophistication of the Japanese economy can be seen in Figure 7. The share of exports represented by food products, intermediate goods and light manufactures has declined steadily since 1966 as shipments of capital equipment and consumer durables have expanded. While capital equipment held a slightly larger share of exports than consumer durables in 1966, its lead widened significantly over this period, emerging as the single most important export group, a fact often overlooked in the frictions over cars and other consumer durables.

In terms of imports, the modest penetration of the Japanese market by imported capital goods and both types of consumer goods shown in Figure 8 is often pointed to as evidence that Japan's markets are closed. While the question of Japan's imports of manufactures is not so simple (see JEI Report No. 14A, April 8, 1988), it is clear that imports of all three groups are growing faster than overall purchases since their relative shares are increasing. Imports are still dominated by industrial supplies, however, reflecting the country's resource-poor land and highlighting the economy's natural emphasis on high value-added products.

A Decade of Change

While data by products and by areas are only available for a decade, the figures are nonetheless instructive. From an aggregate standpoint, the shift of trade toward the industrial countries is very clear (see Tables 1 and 2): 62.3 percent of exports and 47.9 percent of imports came from the developed world in 1987, compared with 47.2 percent and 38.9 percent in 1977. Conversely, the developing countries lost ground, accounting for 32.5 percent of exports and 45 percent of imports in 1987, well below the 46.7 percent and 56.4 percent levels enjoyed 10 years previously. The decline represents a withering of trade with every developing region except Asia: the Middle East's share fell from 11 percent to 4 percent; Latin America's from 7.8 percent to 3.8 percent; and Africa's from 6.2 percent to just 1.3 percent. The drop on the import side was almost completely a reflection of falling oil prices and the stronger yen, lowering imports from the Middle East from 29 percent to 13.5 percent.

The importance of the U.S. market is obvious: its share of Japan's exports rose 49 percent between 1977 and 1987, jumping from 24.5 percent to 36.5 percent. Over the same period the share of Japan's imports sourced from this country also rose, but only from 17.5 percent to 21.1 percent. China also raised its export share by one-half and nearly doubled its share of Japan's imports. Trade with the Soviet Union, however, has been disappointing as far as exports are concerned, falling from 2.4 percent to just 1.1 percent.

A product review points out some interesting developments. The following export categories showed little if any change: food products, nonmetallic mineral manufactures and metal products. The following product groups shifted toward greater trade with the developed countries: light industrial products, textiles, chemicals, machine tools, radios and vehicles. The developing countries take a bigger share of Japanese exports for industrial materials and fuel, heavy industrial products, fertilizers, televisions and ships.

Beyond the obvious points that the developing countries need basic industrial inputs while the developed nations can afford luxuries, the pattern of export changes is a patchwork. For example, why have the rich countries imported a greater share of Japanese exports of radio equipment (a simple technology) while the developing countries are taking a larger portion of television shipments (supposedly a more sophisticated product)? The data do not present a clear answer. Perhaps the developing countries have barred Japanese items for which there are domestic substitutes, forcing Japanese exports into other markets. On the other hand, the sharp rise in offshore production facilities to supply demand previously satisfied by exports may account for some of

the changes (see JEI Report No. 5A, February 5, 1988). Another factor that is not evident from the trade statistics is the level of added value -- Japanese manufacturers have steadily increased the sophistication of the products bound for the markets of the industrial nations, while simple products may be more suitable in the developing countries.

On the import side, the picture is equally interesting for different reasons. The distribution of shares for most product groups is largely unchanged, with two exceptions. First, the communist countries have raised their share of many products mainly at the expense of the developed nations. Equally significant is that the gains appear in both industrial and consumer products. Although not yet a major factor in Japan's trade, the trend is worth watching. Second, the developing countries show great strength in the consumer durables and nondurables areas. The most striking example is in consumer electronics goods, where Japan's share of imports from the developing countries skyrocketed from 53.2 percent in 1977 to 76.1 percent last year.

Outlook

The configuration of Japan's recent trade seems to reflect several major changes:

- The rapid advance of the economy's technological level may explain the increased trade with the industrial world. As Japan produces a greater share of state-of-the-art items, trade with other advanced nations will play an increasingly important role.

- The yen's appreciation has drastically reduced the price competitiveness of domestic products, leading to greater imports as well as a shift to offshore production.

- The effort to restructure the economy, reducing the role of exports and stimulating domestic demand, seems to be compounding the impact of the strong yen. The sudden realization of their affluence may be behind greater Japanese purchases of European goods, such as luxury cars and clothing. Positive economic growth forecasts are also encouraging businesses to raise capital expenditures, while imports are getting greater consideration as a result of the high yen.

- The continued weakness of global commodity prices, particularly for crude oil, has reduced the value of trade with the developing countries, especially when viewed in dollar terms.

- The rapidly growing Asian nations have naturally turned to Japan as a source of industrial supplies and equipment. Trade with South Korea and China has grown tremendously, chalking up a significant surplus for Japan in both cases.

- Japan's dominance of certain products (consumer and industrial electronics, for example) reduces its vulnerability to a loss of trade in these areas as a result of exchange rate changes. Therefore even if an item loses its price competitiveness, other countries must continue to import it, at least until domestic substitutes become available, if ever.

Overall, Japanese trade appears to be on the verge of major changes. If imports of consumer and industrial manufactures continue to grow rapidly, Japan can contribute to continued global growth. At the same time if Japanese industry aggressively pursues research and development, trade in manufactures will remain an important component of the picture. Tokyo can take this opportunity to address one important deficiency: the withering of trade with the poorer developing nations. Japan has long been subject to criticism that its field of view extends only as far as the shores of the Pacific. Fostering trade with Latin America and particularly Africa would yield economic and political benefits. Changes in its trade pattern will reflect whether Japan can rise to meet the higher expectations resulting from its economic ascent.

For further information, contact Jon Choy.

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The views expressed in this report are those of the author and do not necessarily represent those of the Japan Economic Institute.

Figure 1: Japan's Total Trade by Area, 1966-87

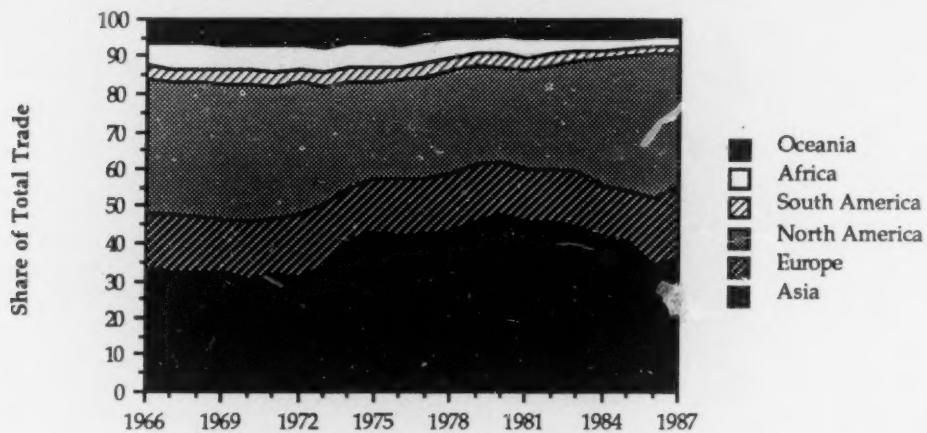


Figure 2: Japan's Exports by Area, 1966-87

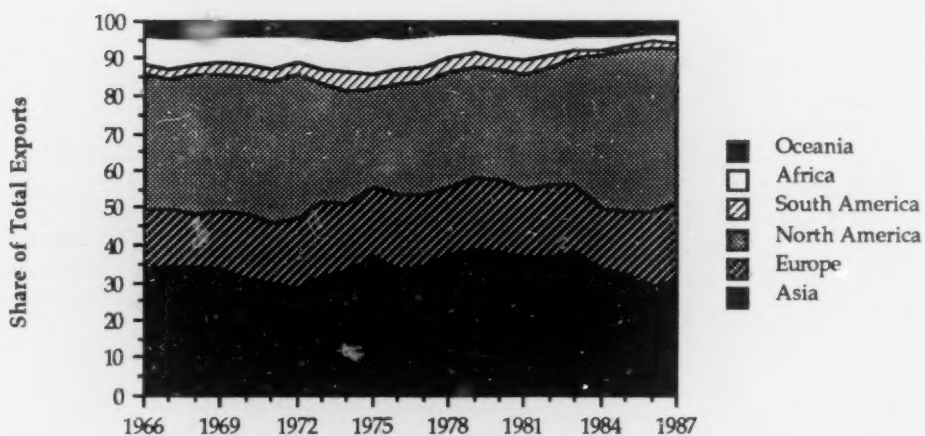


Figure 3: Japan's Imports by Area, 1966-87

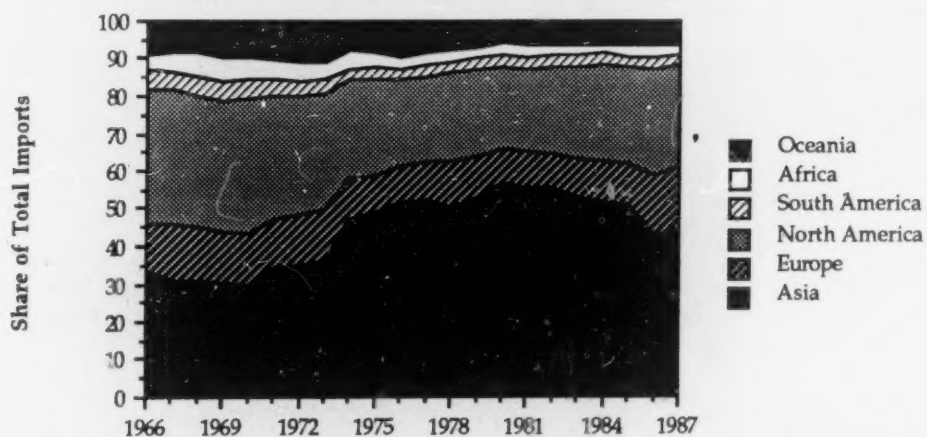


Figure 4: Japan's Total Trade by Bloc, 1966-87

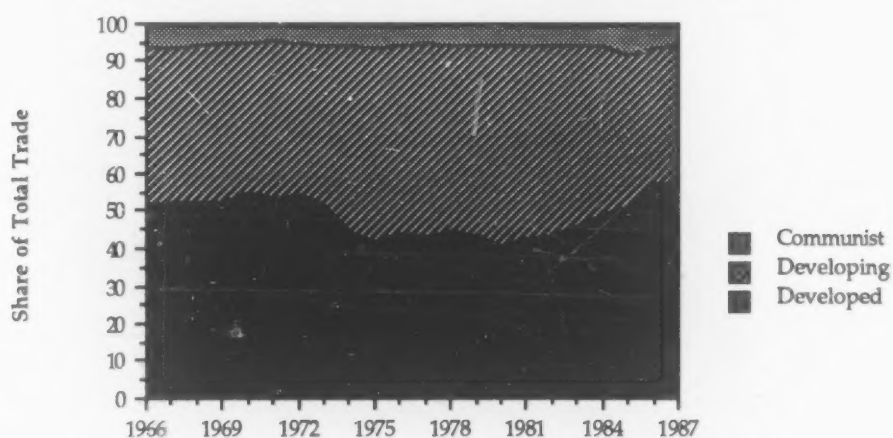


Figure 5: Japan's Exports by Bloc, 1966-87

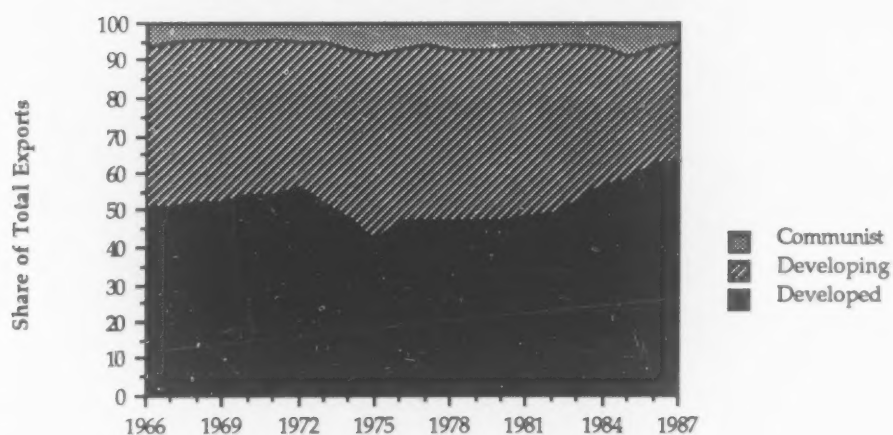


Figure 6: Japan's Imports by Bloc, 1966-87

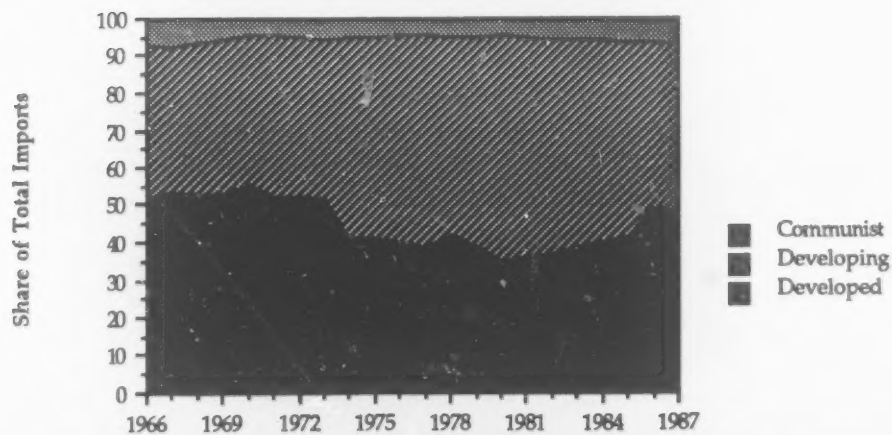


Figure 7: Japan's Exports by Product Group, 1969-87

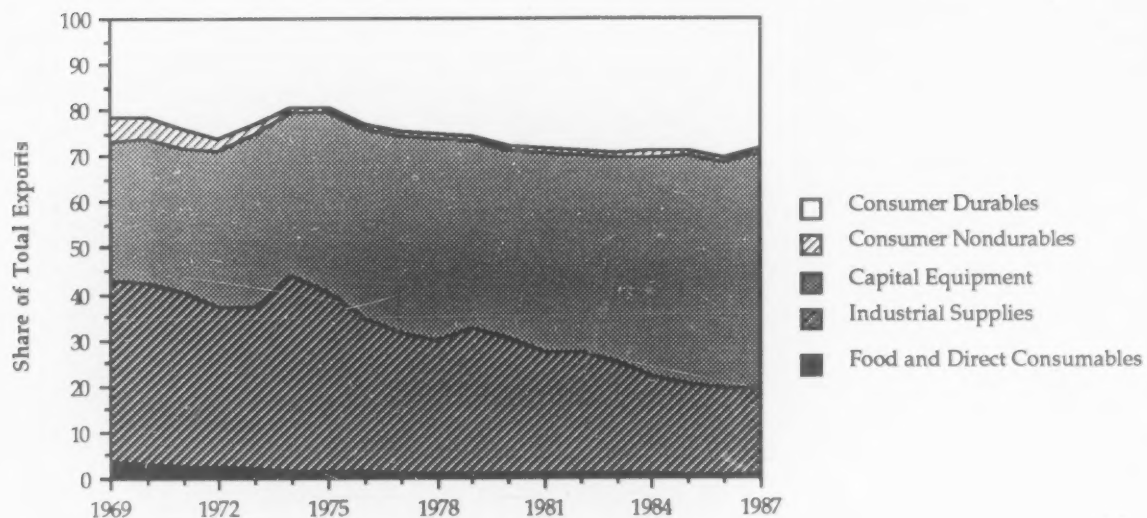


Figure 8: Japan's Imports by Product Group, 1969-87

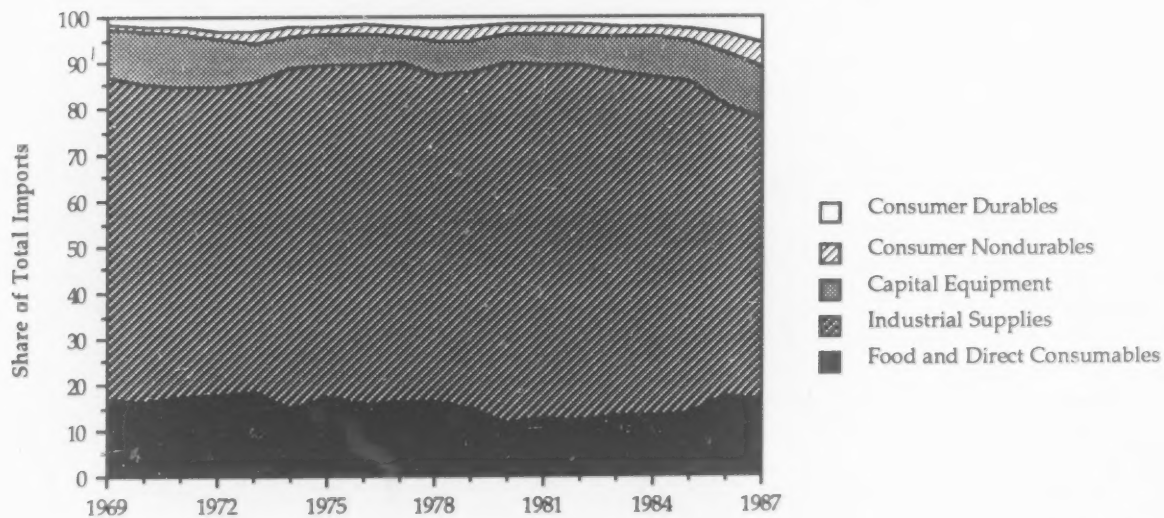


Table 1: Japan's Exports by Product by Country, 1977 and 1987
(percent of total exports)

Area/Country	Food and Direct Consumables		Crude Materials and Fuels		Light Industrial Products		Textiles		Nonmetallic Mineral Manufactures	
	1977	1987	1977	1987	1977	1987	1977	1987	1977	1987
Developed Countries	44.0%	43.6%	36.0%	23.4%	42.8%	55.0%	29.6%	33.9%	48.8%	50.4%
Canada	4.7	3.6	1.1	0.6	2.8	2.5	2.5	1.8	2.7	2.7
United States	22.9	26.1	6.9	10.1	20.7	28.2	14.2	15.3	29.4	32.5
Western Europe	11.7	10.4	23.7	10.4	13.1	20.1	6.4	12.7	10.2	11.4
European Community										
Australia, New Zealand and South Africa	8.8	9.8	21.5	9.8	9.9	17.3	5.0	11.3	7.8	9.3
Developing Countries	4.6	3.4	4.3	2.1	6.1	4.2	6.5	4.1	6.5	3.8
Southeast Asia	55.7	53.7	57.3	65.2	50.4	39.4	59.8	56.9	47.5	45.1
Middle East	25.4	40.6	46.3	55.8	27.4	28.8	33.1	42.5	21.7	38.5
Latin America	13.1	4.3	3.0	4.2	15.1	7.4	17.6	11.1	20.4	3.9
Africa	3.6	2.1	7.0	4.8	4.4	1.8	4.5	1.3	3.0	1.5
Other	9.1	2.2	0.9	0.4	3.1	1.1	4.5	1.8	1.7	0.9
Other	4.5	4.6	0.1	0.0	0.3	0.3	0.2	0.1	0.7	0.3
Communist Countries	0.3	2.6	6.7	11.4	6.8	5.6	10.5	9.1	3.7	4.5
China	0.0	2.2	1.7	4.1	2.4	4.2	4.2	6.9	0.2	3.4
U.S.S.R.	0.1	0.1	2.1	2.7	2.9	0.8	4.3	1.6	2.2	0.6
Eastern Europe	0.2	0.0	1.7	4.3	0.9	0.2	1.3	0.3	0.7	0.2
Heavy Industrial Products										
Area/Country	1977		1987		Fertilizers		Metal Manufactures		Steel	
	1977	1987	1977	1987	1977	1987	1977	1987	1977	1987
Developed Countries	48.0%	63.7%	29.0%	39.6%	3.9%	5.5%	36.7%	33.5%	35.2%	26.8%
Canada	2.0	2.5	0.8	1.0	0.2	0.2	1.7	1.4	1.5	1.2
United States	25.2	37.7	11.3	17.8	0.6	2.3	23.5	22.8	22.0	18.7
Western Europe	16.7	20.0	11.7	17.3	0.3	1.0	8.5	5.6	8.7	3.3
European Community										
Australia, New Zealand and South Africa	10.9	16.5	9.2	15.4	0.1	1.0	4.4	1.0	3.8	1.9
Developing Countries	4.2	3.5	5.1	3.4	2.7	1.9	3.1	3.7	3.1	3.6
Southeast Asia	46.0	31.2	57.0	49.8	29.8	93.8	49.4	46.8	48.2	47.9
Middle East	20.0	22.0	48.3	45.1	20.5	71.1	23.9	37.3	23.8	38.1
Latin America	10.6	3.6	3.1	1.8	0.3	2.4	13.3	4.6	11.7	4.6
Africa	8.4	4.1	4.7	2.3	5.7	8.6	8.4	3.2	9.6	3.6
Other	6.8	1.3	0.6	0.4	1.3	9.5	3.7	1.4	3.9	1.6
Other	0.3	0.2	0.2	0.1	2.1	2.2	0.1	0.2	0.1	0.2
Communist Countries	6.0	5.1	14.1	10.6	66.3	0.8	13.9	19.7	16.6	25.2
China	2.4	3.5	8.0	6.4	64.5	0.7	7.9	13.3	9.8	16.8
U.S.S.R.	2.3	1.1	3.5	2.9	0.0	0.0	4.5	5.8	5.2	7.9
Eastern Europe	0.9	0.3	1.4	0.8	0.0	0.0	1.0	0.3	1.2	0.3

Table 1 (continued)

Area/Country	Machine Tools		Televisions		Radios		Vehicles		Ships	
	1977	1988	1977	1988	1977	1988	1977	1988	1977	1988
Developed Countries	52.8%	68.5%	65.2%	38.5%	66.8%	78.4%	66.4%	85.4%	36.0%	21.5%
Canada	2.2	2.7	6.3	1.4	2.4	2.8	2.9	4.6	0.2	0.0
United States	26.8	40.4	38.1	21.5	33.7	45.5	42.6	56.1	2.0	8.2
Western Europe	19.4	21.7	12.8	13.5	27.5	26.9	14.6	21.7	32.3	12.3
European Community	12.9	17.9	10.8	10.6	21.2	23.0	10.4	15.5	12.1	10.6
Australia, New Zealand and South Africa	4.4	3.5	8.0	2.1	3.2	3.2	6.1	3.0	1.4	0.9
Developing Countries	44.1	28.3	34.5	45.2	32.8	18.9	32.8	14.0	62.3	76.4
Southeast Asia	16.4	18.8	8.7	17.1	7.7	10.7	9.4	4.6	7.0	9.8
Middle East	10.4	3.7	16.8	20.0	12.7	4.5	13.0	4.0	6.3	1.4
Latin America	8.8	4.3	5.5	5.4	6.5	2.9	5.9	3.4	16.8	45.2
Africa	8.2	1.3	3.4	2.4	5.6	0.7	3.8	1.4	32.0	19.7
Other	0.3	0.2	0.2	0.3	0.4	0.1	0.6	0.5	0.2	0.4
Communist Countries	3.1	3.2	0.3	16.3	0.4	2.7	0.8	0.6	1.7	2.1
China	0.4	2.3	0.1	12.2	0.0	1.3	0.4	0.4	0.6	2.1
U.S.S.R.	1.6	0.5	0.0	1.3	0.1	1.1	0.3	0.0	0.8	0.0
Eastern Europe	0.9	0.3	0.1	1.7	0.3	0.1	0.0	0.1	0.3	0.0

Table 2: Japan's Imports by Product by Country, 1977 and 1987
(percent of total imports)

Area/Country	Food and Direct Consumables		Industrial Supplies		Crude Materials		Fuels		Chemicals	
	1977	1987	1977	1987	1977	1987	1977	1987	1977	1987
Developed Countries	59.6%	53.8%	29.1%	38.1%	49.4%	53.9%	12.1%	13.8%	84.7%	77.9%
Canada	8.4	6.0	3.6	4.7	7.8	11.4	2.2	2.9	2.5	2.1
United States	31.7	30.0	11.5	14.5	19.6	22.9	4.3	3.6	38.6	34.4
Western Europe	5.9	8.9	4.0	9.5	1.4	4.2	0.1	0.3	37.4	39.9
European Community	4.1	7.6	3.0	7.5	0.9	3.1	0.1	0.3	29.3	32.1
Australia, New Zealand and South Africa	13.5	13.2	9.9	9.4	20.6	15.4	5.5	7.0	6.2	1.3
Developing Countries	36.6	38.0	65.8	54.6	42.0	38.6	84.6	79.6	12.2	17.4
Southeast Asia	21.7	28.1	21.1	25.2	25.5	26.7	19.9	28.1	9.1	9.7
Middle East	1.0	0.3	39.5	22.6	1.1	1.2	64.4	47.8	0.3	3.8
Latin America	10.2	6.2	3.5	5.4	11.0	7.8	0.2	3.2	2.7	3.8
Africa	3.5	2.7	1.1	0.9	2.1	0.9	0.1	0.5	0.1	0.0
Other	0.3	0.7	0.6	0.5	2.4	1.9	0.0	0.0	0.0	0.0
Communist Countries	3.8	8.2	5.1	7.4	8.6	7.5	3.3	6.6	3.1	4.7
China	2.6	6.3	2.1	4.9	1.8	4.4	2.2	5.4	1.4	3.6
U.S.S.R.	0.6	0.8	2.6	1.9	6.5	2.7	0.8	1.1	1.2	0.4
Eastern Europe	0.4	0.5	0.3	0.3	0.1	0.1	0.2	0.0	0.4	0.7
Area/Country	Metals and Metal Products		Textiles		Capital Equipment		Nonelectric Machinery		Electric Machinery	
	1977	1987	1977	1987	1977	1987	1977	1987	1977	1987
Developed Countries	39.5%	42.4%	38.1%	36.7%	87.5%	84.4%	92.0%	87.1%	77.3%	75.5%
Canada	4.1	2.8	0.2	0.1	0.8	1.0	1.1	0.8	0.5	0.8
United States	4.9	8.5	5.7	6.3	51.2	55.3	50.8	53.2	51.6	55.0
Western Europe	8.8	9.5	32.1	30.1	35.2	27.3	39.9	32.5	24.8	19.6
European Community	4.9	5.8	26.9	27.4	28.6	22.1	32.1	25.9	21.2	16.0
Australia, New Zealand and South Africa	21.7	21.5	0.1	0.1	0.3	0.8	0.2	0.6	0.3	0.1
Developing Countries	46.2	44.0	49.9	39.3	11.9	15.2	7.3	12.4	22.5	24.1
Southeast Asia	19.5	21.5	48.8	37.7	9.6	14.2	3.7	10.9	21.9	23.8
Middle East	4.2	2.0	0.0	0.1	0.1	0.2	0.0	0.2	0.0	0.2
Latin America	10.0	15.6	1.0	1.4	2.2	0.7	3.5	1.3	0.6	0.1
Africa	12.1	4.7	0.0	0.1	0.0	0.1	0.0	0.0	0.0	0.0
Other	0.3	0.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Communist Countries	14.3	13.6	12.1	24.0	0.6	0.4	0.7	0.5	0.2	0.4
China	0.2	3.0	11.7	23.8	0.0	0.3	0.0	0.2	0.0	0.4
U.S.S.R.	9.5	7.4	0.0	0.1	0.3	0.1	0.3	0.1	0.1	0.0
Eastern Europe	2.9	2.3	0.3	0.1	0.3	0.1	0.4	0.2	0.1	0.0

Table 2 (continued)

Area/Country	Transportation Equipment		Consumer Nondurables		Textile Products		Consumer Durables		Household Appliances	
	1977	1988	1977	1988	1977	1988	1977	1988	1977	1988
Developed Countries	87.9%	94.2%	40.5%	31.0%	25.0%	16.9%	70.5%	65.2%	83.8%	65.5%
Canada	0.0	1.7	0.3	0.1	0.4	0.2	1.2	0.3	13.5	0.1
United States	58.0	64.6	12.7	11.1	4.4	2.8	25.9	13.6	15.3	22.8
Western Europe	29.8	25.2	27.2	19.6	20.1	13.7	42.7	50.9	80.6	42.2
European Community	25.4	21.8	24.4	18.1	17.4	12.6	33.5	44.8	40.7	39.8
Australia, New Zealand and South Africa	0.1	2.7	0.3	0.2	0.2	0.2	0.6	0.4	5.1	0.3
Developing Countries	10.3	5.4	51.5	53.5	64.3	62.6	26.1	32.1	14.1	29.6
Southeast Asia	7.9	4.4	51.2	53.0	63.9	62.2	25.8	31.8	13.5	29.2
Middle East	0.6	0.0	0.1	0.2	0.2	0.3	0.1	0.1	0.2	0.1
Latin America	1.8	0.4	0.2	0.2	0.2	0.1	0.2	0.2	0.4	0.2
Africa	0.0	0.6	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Communist Countries	1.8	0.3	8.0	15.5	10.6	20.4	3.5	2.6	5.9	4.9
China	0.0	0.3	7.4	15.1	9.9	20.1	2.3	2.1	2.8	2.2
U.S.S.R.	1.4	0.0	0.0	0.0	0.0	0.1	0.6	0.1	0.1	0.0
Eastern Europe	0.3	0.0	0.5	0.3	0.7	0.2	0.5	0.4	2.9	2.6
Toys and Musical Instruments										
Area/Country	Household Electronics		Automobiles		Instruments					
	1977	1988	1977	1988	1977	1988				
Developed Countries	46.8%	21.5%	100.0%	99.5%	66.8%	46.9%				
Canada	0.1	0.5	1.2	0.2	0.2	0.3				
United States	28.9	6.4	34.8	4.4	40.8	25.7				
Western Europe	17.5	14.5	63.9	20.1	25.6	20.8				
European Community	15.6	12.8	61.5	17.4	21.1	15.6				
Australia, New Zealand and South Africa	0.3	0.1	0.1	0.2	0.2	0.2				
Developing Countries	53.2	76.1	0.0	0.5	32.4	50.9				
Southeast Asia	53.2	76.1	0.0	0.3	32.3	50.2				
Middle East	0.0	0.0	0.0	0.0	0.0	0.0				
Latin America	0.0	0.0	0.0	0.2	0.1	0.6				
Africa	0.0	0.0	0.0	0.0	0.0	0.0				
Other	0.0	0.0	0.0	0.0	0.0	0.0				
Communist Countries	0.0	2.4	0.0	0.0	0.8	2.2				
China	0.0	2.4	0.0	0.0	0.3	2.0				
U.S.S.R.	0.0	0.0	0.0	0.0	0.1	0.1				
Eastern Europe	0.0	0.0	0.0	0.0	0.3	0.1				

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J A P A N · E C O N O M I C · I N S T I T U T E

J E I

R E P O R T

A Two-Part Report: A and B

NO. 16B
April 22, 1988

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Trade Bill Veto Likely

The consensus approach to trade legislation seemed to dissolve during the final days of the conference committee on HR 3, forcing analysts to do an about-face: instead of predicting a moderate bill that the president would sign, they began to forecast a veto. The turning point was an eleventh-hour decision by House Speaker Jim Wright (D, Tex.) and Senate Majority Leader Robert Byrd (D, W.Va.) to include in the bill a controversial provision requiring firms to give employees 60 days advance warning of a plant closing or mass layoffs.

By all appearances the Democrats caved in to labor pressures on this provision. The plant-closing measure has gained a significance disproportionate to the scope of its requirements since the unions have made it a symbolic

no indication of what they might do next. Some observers have suggested that if the president's veto is sustained, legislators should simply remove the offending plant-closing provision and resubmit the bill. But staff members say that procedural difficulties and the leadership's strategies make that option impossible. It is difficult to determine whether this message is intended as a negotiating ploy to persuade the president to sign the bill -- or whether Congress may consider that option if the White House does in fact veto HR 3. It appears, however, that if Congress sustains a presidential veto, that will be the end of trade legislation for the 100th Congress.

Eileen M. Doherty

Unruly Dollar Disrupts G-7 Meeting

At last economic officials seemed to have tamed the world currency markets. Rates had been stable for months and investors who wanted some assurance that they would not lose heavily overseas were beginning to venture into foreign investments again, buoying the markets still further. The finance ministers and the central bankers of the seven leading industrial nations gathered in Washington April 13 to congratulate themselves on their accomplishments and to affirm that they would stay the course they had set. The Group of Seven issued a communique that largely repeated its December statement stressing stable currencies (see JEI Report No. 1B, January 8, 1988).

At first the reaction of the markets was positive and the dollar looked stronger than it had in months. But there was a problem: the meeting coincided with the release of the February U.S. trade data. Although discounted by experts dubious about their reliability, in the last six months the numbers have been blamed for much of the international economic commotion, including the October stock market crash and previous bouts with the plummeting dollar.

As shown in the Table, the figures have generally improved on a month-to-month basis and most officials were obviously hoping for more of the same. Instead, their worst fears were realized. The data, released while some ministers were en route home, showed a deterioration in the trade position generally and in the bilateral balance with Japan. The reaction of the currency markets was swift and negative, sending the dollar plummeting against the yen and other currencies. Hastily arranged meetings among those officials who had not yet headed for the airport and quick market intervention managed to stem the decline, at least temporarily. World central banks and finance ministries reportedly spent \$500 million on the April 14 effort, including at least \$100 million from Japanese authorities.

The currency traders reacted primarily to the deterioration in the U.S. trade position between January and February, but such month-to-month comparisons actually mean little if the data are not seasonally adjusted. If the figures are compared on a year-to-year basis, the just-released February data look less alarming and are, in fact, the best relative performance in months. Even a year-to-year comparison is not without its problems, of course, as, for example, currency-induced price changes can mask real changes. Generally the year-to-year data show a trade deficit that is proving more stubborn than expected, without a clear pattern of decline.

U.S. Trade Balance

(in millions of dollars; exports f.a.s., imports c.i.f.)

<u>August 1987- February 1988</u>		<u>August 1986- February 1987</u>		<u>Percent Change</u>
August 1987	\$15,683	August 1986	\$13,336	17.6%
September 1987	14,076	September 1986	13,817	1.9
October 1987	17,631	October 1986	13,773	28.0
November 1987	13,218	November 1986	14,560	-9.2
December 1987	12,202	December 1986	11,906	2.5
January 1988	12,437	January 1987	11,937	4.2
February 1988	13,828	February 1987	14,365	-3.7

Source: Department of Commerce

By comparison, Japan's trade surplus is clearly contracting (see article in this issue.) The March data, released a few days before the U.S. figures came out, showed a surplus of \$7.5 billion, down 7.4 percent from the year-earlier month. The larger-than-expected drop pulled the yen down a little before being overwhelmed by the bad news from Washington. The net effect of the G-7 meeting, the release of the two sets of trade figures and the intervention was practically a wash, with the dollar worth just a yen less on April 15 than the week before.

Some anxious Japanese officials reportedly saw in the week's events an echo of Black Monday as U.S. stock and currency markets seemed to be pulling each other down in a vicious cycle, threatening other stock exchanges in the process. They see vigorous currency intervention as the solution in such situations. In this view, the action taken in the aftermath of the G-7 meeting and statement was a shrewd way of making a point rather than an embarrassing necessity.

Douglas Ostrom

Japan Pushes For Debt Crisis Initiative

Capping a week of harmonious meetings with the finance ministers and central bankers of the Group of Seven industrial nations (see preceding article), Kiichi Miyazawa announced April 14 Tokyo's willingness to under-write a significant portion of a new initiative aimed at resolving the \$1.2 trillion developing-country debt crisis. Although Japan's finance minister presented only a skeleton plan, the idea received support from officials of both the industrial and the developing countries.

The scheme rejects radical solutions involving large-scale debt forgiveness in favor of traditional International Monetary Fund policies that focus on local economic development. A long-term perspective is necessary, Mr. Miyazawa said, so that the development process does not cause undue social strains and to lighten the debt burden through a lengthened repayment period. The principles of economic restructuring and development must be tailored to individual

its secrecy. Although there is no direct connection between the accord signed April 12 and Japan's involvement in the Strategic Defense Initiative and the development of a next-generation fighter support plane (dubbed the FSX), many hope that the pact will open the door to defense-related technology exchanges that will better facilitate Japan's participation in these defense projects.

The United States pushed for the agreement to insure that Tokyo's policy on patent secrecy was adequate to protect the American technology that would be going into the FSX and other prospective joint defense projects. Japan enacted a patent secrecy law in 1956, but never effectively enforced it because of strong domestic opposition to allowing the government to hold industrial secrets. Thus, for the past 30 years, Tokyo could not guarantee confidentiality for U.S. defense-related patent applications because all files in the office were open to the public.

For its part, Washington prohibits holders of Pentagon classified patents from applying for patents in countries that cannot guarantee their secrecy. (The State Department says Washington currently has secrecy guarantees from approximately 15 countries, most of which are members of the Coordinating Committee on Multilateral Export Controls.) The result has been a considerable barrier to defense-related technology exchanges between the United States and Japan.

In order to satisfy both countries' statutory requirements, the new agreement stipulates that the Japan Defense Agency -- rather than the Patent Office of the Ministry of International Trade and Industry -- will act as the confidential repository of all U.S. patent applications with secrecy orders until the Pentagon declassifies them. In addition to enhancing national security, the accord is expected to benefit U.S. defense and high technology companies that until recently risked losing licensing fees and other monies from Japanese companies for commercial spin-offs of their products.

According to the U.S. Patent Office, last year it held about 5,000 high technology applications, 400 of which were classified. These covered products in industries such as electronics, aerospace and advanced composite materials, to name a few.

Barbara Wanner

Japan's Trade Surplus Continues To Shrink

Three years after the dollar topped out on foreign exchange markets, the monthly U.S. trade numbers finally seem to be moving in the right direction. But with the improvement coming by fits and starts, few Reagan administration officials or business economists are prepared to go out on a limb and state flatly that the corner has been turned. Trade watchers in Japan, whether in the government or outside, are not in the same bind. The country's huge trade surplus is not only headed down but is shrinking faster than many analysts expected, thanks to the one-two punch of a strong yen and booming domestic demand. The January-March 1988 period marked the fourth straight quarter that the gap between exports and imports in dollar terms narrowed on a year-to-year basis. Add to this the fact that the surplus contracted 19 percent in the

first quarter after dropping 15.6 percent in October-December 1987, 20.8 percent in the preceding three-month period and 5.5 percent in the April-June quarter and it is clear that the long-awaited turnaround in Japan's trade account has occurred.

Although the export-import gap is clearly shrinking, economists in Japan are starting to question how much longer the dollar-denominated surplus will contract by the big margins of recent months. Triggering this concern is new evidence that major Japanese exporters have lowered their break-even point to about ¥130=\$1.00. Overseas sales have expanded by double-digit margins for the last five months, including gains of 17 percent-plus in both February and March. Part of this growth reflects the yen's continuing rise against the dollar, but the volume of shipments, which had dipped in 1987's second and third quarters, has also increased, going up by 2.8 percent in the October-December period and 2.5 percent in this year's first three months.

While a contraction in the volume of overseas sales obviously makes life easier for Takeshita administration trade policymakers, additional gains in price-adjusted exports will not reverse the trend toward a significantly smaller Japanese trade surplus as long as imports continue to soar. But this caveat could become a problem. Purchases from abroad in dollar terms have jumped by more than one-third in each of the last two quarters, boosted in part by volume hikes of 13.6 percent in 1987's final quarter and 21.3 percent in the January-March period. Simply from an arithmetic standpoint, this performance will be hard to repeat in the coming quarters; any faltering in domestic demand will make it next to impossible.

Susan MacKnight

The views expressed in this report are those of the authors and do not necessarily represent those of the Japan Economic Institute.

Japan's Total Trade in Dollar Terms

(in millions of dollars)

	<u>Exports</u> <u>(f.o.b.)</u>	<u>Change Over</u> <u>Year-Earlier</u> <u>Period</u>	<u>Imports</u> <u>(c.i.f.)</u>	<u>Change Over</u> <u>Year-Earlier</u> <u>Period</u>	<u>Trade</u> <u>Balance</u>
1983	\$146,928	5.8%	\$126,393	-4.2%	\$20,534
1984	170,114	15.8	136,503	8.0	33,611
1985	175,638	3.2	129,539	-5.1	46,099
1986	209,151	19.1	126,408	-2.4	82,743
1987	229,221	9.6	149,515	18.3	79,706
1986: I	45,499	18.2	33,005	1.5	12,494
II	53,166	21.5	31,424	-2.1	21,742
III	54,768	24.7	30,153	-3.5	24,615
IV	55,718	12.6	31,826	-5.5	23,892
1987: I	51,464	13.1	31,977	-3.1	19,487
II	56,931	7.1	36,380	15.8	20,551
III	57,855	5.6	38,346	27.2	19,509
IV	62,972	13.0	42,812	34.5	20,159
1988: I(p)	60,197	17.0	44,418	38.9	15,779

Japan's Total Trade in Yen Terms

(in billions of yen)

	<u>Exports</u> <u>(f.o.b.)</u>	<u>Change Over</u> <u>Year-Earlier</u> <u>Period</u>	<u>Imports</u> <u>(c.i.f.)</u>	<u>Change Over</u> <u>Year-Earlier</u> <u>Period</u>	<u>Trade</u> <u>Balance</u>
1983	¥34,909	1.4%	¥30,014	-8.1%	¥4,895
1984	40,325	15.5	32,321	7.7	8,004
1985	41,956	4.0	31,085	-3.8	10,871
1986	35,290	-15.9	21,551	-30.7	13,739
1987	33,315	-5.6	21,737	0.9	11,578
1986: I	8,674	-12.4	6,334	-24.1	2,339
II	9,119	-17.3	5,399	-33.3	3,720
III	8,632	-18.5	4,758	-36.8	3,874
IV	8,865	-15.1	5,060	-28.9	3,806
1987: I	7,960	-8.2	4,959	-21.7	3,002
II	8,153	-10.6	5,207	-3.6	2,946
III	8,507	-1.5	5,644	18.6	2,864
IV	8,694	-1.9	5,928	17.2	2,767
1988: I(p)	7,703	-3.2	5,677	14.5	2,026

Japan's Trade with the United States in Dollar Terms

(in millions of dollars)

	Exports (f.o.b.)	Change Over Year-Earlier Period	Imports (c.i.f.)	Change Over Year-Earlier Period	Trade Balance
1983	\$42,829	17.9%	\$24,648	1.9%	\$18,181
1984	59,937	39.9	26,862	9.0	33,075
1985	65,278	8.9	25,793	-4.0	39,485
1986	80,456	23.3	29,054	12.6	51,401
1987	83,580	3.9	31,491	8.4	52,090
1986: I	16,696	25.1	6,278	-7.3	10,418
II	20,921	24.3	8,305	25.1	12,616
III	21,280	28.1	7,525	23.1	13,755
IV	21,559	16.7	6,946	10.8	14,613
1987: I	18,001	7.8	6,966	11.3	11,015
II	21,181	1.2	7,592	-8.6	13,589
III	21,628	1.6	8,252	9.7	13,376
IV	22,770	5.6	8,660	24.7	14,110
1988: I(p)	22,665	25.9	10,056	43.9	9,776

Japan's Trade with the United States in Yen Terms

(in billions of yen)

	Exports (f.o.b.)	Change Over Year-Earlier Period	Imports (c.i.f.)	Change Over Year-Earlier Period	Trade Balance
1983	¥10,179	12.9%	¥5,855	-2.3%	¥4,323
1984	14,221	39.7	6,364	8.7	7,858
1985	15,583	9.6	6,213	-2.4	9,369
1986	13,564	-13.0	4,918	-20.9	8,646
1987	12,148	-10.4	4,582	-6.8	7,566
1986: I	3,191	-6.9	1,203	-30.7	1,988
II	3,589	-15.4	1,421	-15.1	2,168
III	3,355	-16.3	1,190	-19.3	2,165
IV	3,429	-12.1	1,104	-16.9	2,325
1987: I	2,786	-12.7	1,083	-9.9	1,703
II	3,034	-15.5	1,086	-23.6	1,948
III	3,180	-5.2	1,215	2.1	1,965
IV	3,148	-8.2	1,198	8.5	1,950
1988: I(p)	2,537	-8.9	1,286	18.7	1,251

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J A P A N · E C O N O M I C · I N S T I T U T E

JEI

R E P O R T

A Two-Part Report: A and B

NO. 17B
April 29, 1988

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House And Senate Approve Trade Bill; Veto Likely

The House of Representatives approved the conference committee's compromise trade bill April 21 by an overwhelming 312-107 majority, more than enough to override the expected presidential veto. The debate centered largely around a provision requiring employers to give advance notification of plant closings or mass layoffs. It was the inclusion of this item in the bill that shifted the White House message from "willing to negotiate" to "ready to veto."

Third, the visibility of Japanese products encourages attention. The success that Japanese industry has had in penetrating the U.S. market is obvious from the number of Japanese cars and other consumer items that Americans see every day. Far less conspicuous are Dutch and British products. The recent rapid expansion of Japanese investment here -- whether in production facilities, real estate or financial terms -- has served to sharpen the debate.

Then, too, some observers argue that Americans perceive Japan's direct investments as more exclusionary than those of other countries. Because top management positions are often held by Japanese, these observers argue, American workers believe they have fewer opportunities for advancement. And finally, charges of racism abound. Critics on both sides of the Pacific argue that the emphasis on Japan's economic activities has overtones from which this country's Anglo-Saxon trading partners do not suffer.

The extent to which each of these factors influences the foreign investment debate is open to question. Still, they all play at least some role in what many analysts fear is an increasingly xenophobic environment. But even this label shifts the debate into dangerous waters. Some congressional staff members have begun to lament the fact that the debate has thus far been limited to simplistic and emotional terms. What would be more useful, they say, is a rational discussion of the effects of foreign investment on this country's economy, national security and growing feelings of economic nationalism.

Eileen M. Doherty

Japan's International Financial Power

Japanese investors triggered last year's stock market crash, the most calamitous financial event in recent memory, according to the head of the White House task force that studied the October event. Nicholas Brady, who may be in line for a high position if the Republicans retain the presidency, says Japanese firms dumped enormous amounts of U.S. government securities before the crash, pulling down the bond market and setting the stage for the collapse of equity prices.

Mr. Brady's comments are unlikely to be the last word on the subject since, for one thing, economists and stock market analysts are still trying to figure out the 1929 stock market crash. Obviously many people in the government and the private sector share responsibility for the latest disaster, but Mr. Brady's statement indicates the increased muscle of Japanese financial institutions.

The statement also underscores fears that Japanese investors may precipitously pull out of U.S. bond and equity markets, dragging them down and sending interest rates up and the dollar down. With their large financial holdings here, however, Japanese institutions have a stake in the stability of the dollar; the Japanese government has clearly been acting to protect that interest.

One indication comes from Japan's foreign currency reserves, now at a record high and the largest in the world, slightly ahead of Germany's. As the Table shows, growth has been accelerating in recent months; reserves reached a level of \$84.9 billion at the end of March. Most of these reserves are in the form of short-term government securities, although a little over \$1 billion is

in gold. The monthly increases in early 1988 are considerably smaller than those recorded in the corresponding months of last year, but the rate of increase is still large compared to most previous years.

Japan's Foreign Exchange Reserves

(in billions of dollars at end of each period)

	<u>Level</u>	<u>Change From Previous Period</u>
1982	\$23,262	\$-5,141
1983	24,496	1,234
1984	26,313	1,817
1985	26,510	197
1986	42,239	15,729
1987	81,479	39,240
1988		
January	83,407	1,928
February	83,821	414
March	84,857	1,036

Source: Ministry of Finance

Higher foreign exchange reserves have several implications. For one thing they suggest that the Japanese government is earning more than \$2 billion a year in interest income on foreign securities, much of it in the United States. In 1986 and 1987, however, this was probably more than offset by a capital loss in yen terms on its dollar-denominated securities.

More importantly the higher reserve levels indicate activity in support of the dollar. One way to prop up the U.S. currency is for Japanese monetary authorities to buy dollars for yen, thereby adding to Japan's foreign currency reserves. As such, the figures represent past intervention. However, the Table does not give the complete picture since it includes only gold, cash and securities with a maturity of less than a year. Long-term assets are not included; in fact, they are not disclosed since the government does not want to tip its hand on the full extent of its intervention in the currency markets.

Outsiders can only hazard a guess as to the full extent of intervention. Pierre Languetin, the outgoing head of the Swiss National Bank, estimates that central bank intervention of all countries in 1987 totaled \$140 billion, but Lloyds Bank PLC puts it at only \$100 billion. With the dollar-yen exchange rate the focus of so much speculation last year, it is likely that Japan accounted for a fair chunk of the total.

Douglas Ostrom

Japan's Money Supply Still Surging

As a general proposition prices and the money supply are supposed to move together. Economists are quick to explain why the two may not be in

unusual step of asking the Ministry of International Trade and Industry to encourage some petrochemical producers to reopen shut-down plants, arguing that the increased production would reduce inflationary pressures. The bank's study also showed, as have previous studies, that increases in the money supply lead to price increases after a lag of several months. While few are expecting a return of the virulent inflation of the mid 1970s, Japan's years of remarkable price stability may be ending.

Douglas Ostrom

Research And Development Stunted In Japan?

Difficult economic conditions in fiscal 1986 (ending March 31, 1987) pared gains in research and development outlays by 15,500 Japanese organizations to just 3.4 percent in nominal terms, the smallest rise in at least 15 years. After adjusting for inflation, the figure improved to 4.1 percent, still the lowest since fiscal 1976's 3.5 percent increase. Although many analysts have argued that Japan does not cut research outlays during a downturn, adjusting to the stronger yen clearly blunted the growth of research spending.

According to a Management and Coordination Agency survey, total spending for research and development by 2,000 universities, 1,400 research organizations and 12,100 companies reached Y9,192.9 billion (\$73.5 billion at Y125=\$1.00) in fiscal 1986, a gain of Y302.6 billion (\$2.4 billion). The rise was just one-quarter the previous year's 12.6 percent increase (see JEI Report No. 43A, November 13, 1987). In real terms the picture was only marginally brighter, with FY 1986's 4.1 percent showing still well below the 11 percent mark of the previous year. Because overall economic growth also lagged in fiscal 1986, R&D spending as a percentage of gross national product showed only a small decline from 2.77 percent to 2.75 percent. Compared to other countries, Japan is behind the United States, which spent \$118.6 billion in fiscal 1986 or 2.82 percent of GNP, and West Germany, which devoted 2.83 percent of total output or DM52.2 billion (\$31.4 billion at DM1.66=\$1.00) in fiscal 1985 to research.

While private firms and research organizations retained their respective shares of total research outlays (see Table 1), the percent spent by universities continued to decline gradually. On the whole, the role of the government edged up a tiny 0.3 percentage point in FY 1986 to 21.3 percent of total outlays. In terms of growth, industry clearly pulled back in fiscal 1986 as the growth rate fell from 15.6 percent to just 3 percent.

The distribution among basic, applied and development research was almost unchanged from the previous year (see Table 2). Although industry has trumpeted a realignment of spending priorities to produce more basic research, company funds for this type of work rose only 0.2 percentage point to 6.1 percent. Similarly, despite a pledge to increase applied research by university laboratories, the distribution of funds was completely unchanged.

On closer examination it is clear that industry's response to hard economic times varied widely with respect to funding research (see Table 3). At one end of the spectrum, the pharmaceutical industry held growth to zero; at

Table 1: Japan's R&D Expenditures, FY 1981-FY 1986

(in billions of yen and percent)

<u>Fiscal Year</u>	<u>Companies</u>	<u>Research Institutions</u>	<u>Universities</u>	<u>Total</u>
1981	Y3,629.8	Y906.9	Y1,445.6	Y5,982.4
Change	15.5%	18.7%	7.9%	14.0%
Share	60.7%	15.2%	24.2%	100.0%
1982	4,039.0	949.3	1,540.4	6,528.7
Change	11.3%	4.7%	6.6%	9.1%
Share	61.7%	14.5%	23.6%	100.0%
1983	4,560.1	971.0	1,649.6	7,180.8
Change	12.9%	2.3%	7.1%	10.0%
Share	63.5%	13.5%	23.0%	100.0%
1984	5,136.6	1,033.1	1,724.2	7,893.9
Change	12.6%	6.4%	4.5%	9.9%
Share	65.1%	13.1%	21.8%	100.0%
1985	5,939.9	1,160.6	1,789.8	8,890.3
Change	15.6%	12.3%	3.8%	12.6%
Share	66.8%	13.1%	20.1%	100.0%
1986	6,120.2	1,240.2	1,832.6	9,192.9
Change	3.0%	6.9%	2.4%	3.4%
Share	66.6%	13.5%	19.9%	100.0%

Table 2: Japan's R&D Expenditures by Type of Research, FY 1985-FY 1986

(in billions of yen and percent)

<u>Fiscal Year</u>	<u>Basic</u>	<u>Applied</u>	<u>Development</u>
<u>1985</u>			
Companies	Y351.7	Y1,303.2	Y4,285.1
Share	5.9%	21.9%	72.1%
Research Organizations	131.5	320.4	616.1
Share	12.3%	30.0%	57.7%
Universities	547.4	378.2	84.7
Share	54.2%	37.4%	8.4%
<u>1986</u>			
Companies	371.3	1,321.8	4,427.1
Share	6.1%	21.6%	72.3%
Research Organizations	156.9	312.1	668.5
Share	13.8%	27.4%	58.8%
Universities	574.7	396.9	89.5
Share	54.2%	37.4%	8.4%

Table 3: Japan's R&D Expenditures by Industry, FY 1985-FY 1986

(in billions of yen and percentage change)

	FY 1985		FY 1986	
	<u>Total</u>	<u>Change</u>	<u>Total</u>	<u>Change</u>
Agriculture	Y4.5	-6.1%	Y4.3	-3.2%
Mining	21.7	15.8	21.7	-0.4
Construction	110.8	-4.6	121.1	9.3
Manufacturing	5,543.6	16.1	5,739.6	3.5
Food Products	133.5	7.9	147.2	10.3
Textiles	62.6	5.3	62.7	0.2
Pulp and Paper	32.4	11.2	33.9	4.7
Publishing and Printing	18.4	33.1	16.4	-10.9
Chemicals	936.4	9.8	983.6	5.0
Industrial Chemicals and				
Synthetic Fibers	377.8	9.1	709.0	8.3
Oils and Paints	89.2	5.9	97.9	9.7
Pharmaceuticals	341.9	15.8	342.0	0.0
Other	127.4	0.4	134.8	5.7
Petroleum and Coal Products	68.3	21.9	68.6	0.5
Plastic Products	65.6	2.4	70.0	6.7
Rubber Products	79.8	16.7	80.2	0.5
Nonmetallic Mineral Products	174.2	32.7	187.6	7.7
Steel	240.4	25.2	255.3	6.2
Nonferrous Metals	100.5	14.7	110.2	9.6
Fabricated Metal Products	102.7	23.0	94.7	-7.8
Nonelectric Machinery	382.7	13.4	379.1	-0.9
Electric Machinery	1,938.2	18.6	1,980.0	2.2
Communications and Electronics				
Equipment	1,322.0	20.6	1,360.4	2.9
Other	616.2	14.5	619.6	0.5
Transportation Equipment	935.7	15.8	989.8	5.8
Motor Vehicles	797.2	16.1	840.4	5.4
Other	138.5	13.9	149.4	7.9
Precision Machinery	201.7	20.5	199.2	-1.3
Other	70.6	5.4	81.2	14.9
Transportation, Communications				
and Utilities	259.3	17.6	233.5	-0.03
Total	5,939.9	15.6	6,120.2	3.0

Source for Tables 1-3: Management and Coordination Agency, Report on the Survey of Research and Development.

the other end, outlays by food product makers rose a healthy 10.3 percent. There appears to be no pattern. Export-oriented firms, which might have been expected to retrench, showed mixed results. Electronics and communications equipment manufacturers, for example, expanded outlays only 2.9 percent. Automotive makers, on the other hand, raised expenditures by nearly twice this amount. As for companies that focus on domestic demand, compare the strong growth of food product makers with the 10.9 percent cut in outlays by publishers and printers. Even levels of technological sophistication appear to have had little impact on spending changes. For example, solid growth in steel and nonferrous metals compared with weak growth by machine tool and electric machinery makers. It was clearly a chaotic year for budget planners.

Japan's technology trade also marked time. Total exports fell 4.3 percent in value terms and 7.1 percent in quantity, while imports shrank 11.1 percent and 2.4 percent, respectively. More significant was the reduction in the exchange of newly signed technology agreements, which had been moving generally upward. New exports dropped from 2,099 cases worth Y73.3 billion (\$586.4 million) in fiscal 1985 to 1,730 cases valued at Y51.8 billion (\$414.4 million) in the April 1986-March 1987 period, while new imports dropped to 1,141 cases from 1,245 cases, although their value rose slightly to Y33.6 billion (\$268.8 million). Japan still showed a significant surplus in technology trade of Y18.2 billion (\$145.6 million), but this was far less than FY 1985's Y40 billion (\$320 million) level.

Despite all the Japanese rhetoric about being bullish on investing in future innovation, it is clear that economic difficulties restrain research budgets. Given industry's strong rebound from a difficult year, figures for fiscal 1987 should show a return to healthy growth.

Jon Choy

Trying To Find Middle Ground On Beef And Citrus

Japan has quietly done an about-face on trade in beef, oranges and orange juice. Elimination of the import quotas on these commodities -- dismissed up until a few weeks ago as impossible, at least in the medium term -- is now accepted as inevitable by 1993 at the latest, not only by senior members of Noboru Takeshita's government but by Liberal Democratic Party policymakers and farm group representatives as well. If matched by some flexibility in Washington's position, this little-publicized policy reversal opens the way for a cease-fire in the decade-long bilateral fight over access to Japan's beef and citrus markets.

Hints that Japan was prepared to go beyond its rejected March offer of continued annual increases in the quotas on beef, oranges and orange juice surfaced after talks April 13-14 in Washington between Deputy U.S. Trade Representative Michael Smith and Hidero Maki, vice minister of agriculture for international affairs. By the end of another round of Maki-Smith discussions in Tokyo April 19-22, it was clear that Japan had proposed a timetable for liberalization, although neither government directly acknowledged that the Takeshita administration had fulfilled the White House's precondition for negotiations on a replacement for the bilateral beef and citrus arrangement

JEI

A Two-Part Report: A and B

NO. 18A

May 6, 1988

JAPAN'S FISCAL POLICY

Summary

When Tokyo announces a new budget, Washington listens. It hasn't always been so, of course. Only a few years ago Japan's economy was so small that even major changes in government spending or taxes had virtually no effect on the U.S. economy. In fact, government spending and taxes still have a much larger influence westward across the Pacific than in the other direction, and Japan's tremendous interest in the U.S. government budget deficit reflects this orientation. Increasingly, though, U.S. officials are letting the Japanese know that how they spend government yen matters to Washington. This might appear peculiar since the funds represent taxes paid by Japanese firms and individuals and government expenditures in Japan. Still, the interest in this apparently internal matter is well-placed. A close look at the Japanese budget reveals a fiscal policy that recognizes Japan's international responsibilities, but that might leave some Americans wondering whether Tokyo could do still more.

An International Perspective

It's easy enough to see some of the ways foreign trade matters to the American economy. When a Detroit auto worker loses his job, he blames foreign competition. The wheat farmer is at least as sophisticated; a weak dollar helps his product find a market overseas. Each may also believe, rightly or wrongly, that actions by foreign governments may influence his ability to earn a living by making it harder or easier to compete against products from those foreign countries. He is right, in more ways than he realizes. Not only do

product-specific measures like subsidies or tariffs have the potential to really throw American workers for a loop, but foreign government actions that appear to affect only that economy may have an even greater impact.

Fiscal policies -- changes in government spending and taxes leading to changes in the amount of goods and services produced in the economy -- are a case in point. The effect of American policies on Japan is the easiest to see and has received the most publicity, although the process works, with less force, in the opposite direction. For instance, since at least 1981 the United States has reduced federal taxes relative to government spending, with the result that it faces much larger budget deficits that must be financed somehow. If the government, or anyone else, spends more than it takes in someone somewhere has to do the reverse; there has to be saving.

What many feared when the 1981 tax cuts were enacted was that business firms would be crowded out of the capital markets by government borrowing to replace the lost tax revenues and that the increased budget deficits would be matched by smaller levels of corporate spending. That may well have happened to some degree. Of course, it would have been possible for more government borrowing to be offset by increased household saving, but as generally expected, Americans went right on spending.

Help, if that's the word, came from a somewhat unexpected source: the Japanese household, which produced much more than it spent, allowed Japan to sell abroad more than it bought. These savings, in effect, have financed part of the U.S. budget deficit, leading to the so-called twin deficits in trade and government spending. If the Japanese government should spend more -- pursue an expansionary fiscal policy -- that would keep some of the savings at home, and slow the trans-Pacific flow of funds. That would in turn mean that the government here would have to finance its deficit by outbidding corporations and households for domestic funds, sending overall interest rates higher in the process. Putting it all together, higher Japanese government spending could make it harder for Americans to buy a new house; reducing the trade deficit could also increase the income and job security of Detroit's auto workers.

All these conclusions depend on American and Japanese government behavior and saving decisions. For example, Table 1 shows that the U.S. saving rate is much lower than Japan's and lower than most, but not all, members of the Organization for Economic Cooperation and Development. Compared to net household saving data, a frequently used measure that shows the United States to be in an even less favorable position, gross saving -- the measure used in the table -- includes corporate saving in the form of consumption of fixed capital. It is the amount available for public and private investment and international capital flows. By this measure, the United States manages to beat out only Greece, Belgium, Iceland and Denmark among the 22 OECD countries surveyed in 1985.

Japan's savings put it at the top of the OECD countries. High Japanese savings, low American savings and high U.S. government spending have led to increased Japanese capital flows into the United States, as reflected in the

current account deficit. Japan is, of course, not the only contributor, a number of other major countries also run bilateral surpluses with the United States.

Table 1: Gross Saving as a Percentage of GNP

	<u>1970</u>	<u>1975</u>	<u>1980</u>	<u>1985</u>
United States	18.3%	18.1%	19.2%	16.5%
Japan	40.2	32.3	31.1	31.4
West Germany	28.1	20.9	21.8	22.2
France	26.2	23.0	22.2	18.0
United Kingdom	21.9	15.5	18.4	19.2
Italy	24.2	20.1	22.5	17.7
Canada	21.2	21.1	22.9	18.6
Other OECD Countries*	26.2	23.5	21.6	21.5
Total OECD	23.4	21.5	22.0	20.2

*Includes Australia, Austria, Belgium, Denmark, Finland, Greece, Iceland, Ireland, Luxembourg, Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland and Turkey.

Source: Organization for Economic Cooperation and Development

Of course, if the government of Japan borrowed more, the savings would be absorbed internally to finance the budget deficit. While in the late 1970s and early 1980s government borrowing as a percent of the gross national product was higher in Japan than in the United States, that is no longer true (see Table 2). Most of the large OECD countries surveyed have managed to reduce government deficits slightly since 1982, but Tokyo appears to have been the most successful.

There is another possibility. Private investment could absorb the savings in Japan that the government does not use. While such investment has been reasonably high, it has not been enough to overcome the other effects. The data for fiscal 1987 are not yet available, but in FY 1986 the effect of household savings was very apparent. As Table 3 shows, it was large enough to finance part of corporate investment and the government deficit, with lots left over for overseas capital flows.

The data in Table 3 do not permit the easy conclusion that if the government deficit had been larger, there would have been a one-to-one reduction in the current account surplus. The whole economy would be affected by such an action and all the figures in the table would end up at least slightly different. It is probable, though, that the surplus would decline significantly, just as the U.S. budget and trade deficits have risen almost exactly in tandem.

Table 2: General Government Fiscal Balances

(surplus or deficit (-) as percent of nominal GNP or GDP)

	1982	1983	1984	1985	1986	OECD Estimate	
						1987	1988
United States	-3.5%	-3.8%	-2.8%	-3.3%	-3.5%	-2.4%	-2.4%
Japan	-3.6	-3.7	-2.1	-0.8	-0.9	-1.2	-1.1
West Germany	-3.3	-2.5	-1.9	-1.1	-1.2	-1.7	-2.3
France	-2.8	-3.2	-2.7	-2.9	-2.9	-2.8	-2.7
United Kingdom	-2.3	-3.6	-3.9	-2.9	-2.6	-2.1	-1.9
Italy	-11.3	-10.7	-11.5	-12.3	-11.2	-10.3	-10.0
Canada	-5.9	-6.9	-6.6	-7.0	-5.5	-4.4	-3.3
Other OECD Countries*	-4.8	-5.1	-4.2	-4.1	-3.4	-2.9	-2.9
Total OECD**	-4.0	-4.2	-3.4	-3.4	-3.3	-2.7	-2.6

*Other OECD countries in this sample include Australia, Austria, Belgium, Denmark, Finland, Greece, Netherlands, Norway, Spain and Sweden.

**1982 GNP/GDP weights and exchange rates.

Source: Organization for Economic Cooperation and Development

Table 3: Capital Supply and Use in Japan, FY 1986

(in trillions of yen)

	<u>Savings and Capital Supply</u>	<u>Capital Formation</u>	<u>Imbalance</u>
Households	Y49.4	Y16.9	Y32.5
Nonprofit Institutions			
Serving Households	1.4	1.2	0.2
Government	15.2	18.8	-3.7
Corporations	39.3	55.6	-16.3
Statistical Discrepancy			1.5
Equals Surplus of Funds			14.2*

*The surplus of funds approximately equals the current account surplus. At ¥159.83=\$1.00, the average exchange rate in FY 1986, the surplus of funds was \$88.8 billion.

Source: Calculated from data provided by Economic Planning Agency.

Effects of Fiscal Policy

Exactly how fiscal policies play out is a highly controversial area of economics. For one thing it is possible that a given action has a different effect depending on the existing state of the economy and that the effects differ by country. One factor is the government's share of the economy. The larger its role, the more potent fiscal policy is likely to be. According to OECD data, Sweden had the largest governmental sector of the 18 industrial countries surveyed in 1985 at 64.5 percent of gross domestic product. Switzerland had the smallest figure at 30.9 percent. The average for the 18 was 41 percent. The data show Japan and the United States had among the smallest governmental sectors, 32.7 percent and 36.7 percent, respectively. Japan and the United States showed a pattern of convergence between 1966 and 1980, but since 1980 the gap has been widening again.

Of course, outlays are only part of the picture. As might be expected from the earlier discussion, taxes have been higher relative to expenditures in Japan. The United States had the lowest overall tax burden among the 18 OECD countries at 31.1 percent of GDP in 1985; Japan was right behind at 31.2 percent. Japan's ratio climbed to the highest point in at least 20 years and the United States was close to its highest level.

These outlay and tax figures suggest that government has been getting larger by either measure in the past 20 years in both countries, especially Japan. But both countries are unusual in having comparatively small governments. The distinctive comparison in fiscal policy in the United States and Japan is not the level of government spending or taxes, but the difference between them: the budget deficit. Furthermore, the relative size of the two deficits has very obvious implications for economic and political relations through the effects on the bilateral current account balance.

The effects of fiscal policy are complex and controversial. Increased government spending or reduced taxes create a new source of demand in the economy, either as the government goes into the market to buy the labor and goods it wants, or else as consumers use their larger after-tax incomes to buy more. Additional increases may follow as the recipients in the first round of spending raise their own consumption levels. On the other hand, increased government expenditures could price other buyers out of the market. For example, if the government borrows to finance higher expenditures, it may push interest rates up and affect the interest-sensitive housing market. Or, government spending and/or tax cuts could ignite inflation, with adverse effects on the spending plans of those whose income increases fail to match the rate of price hikes.

The effects do not stop there. Increased government spending may result in more highways, parks or educational facilities that in turn will have their own effects on the economy, sometimes raising it further if the productive power of the economy is augmented. Or, this expenditure may improve the quality of life even if it does little to boost GNP.

Government spending, of course, has negative effects too. More government spending may crowd out investment by private firms that would have led to increased productive potential. If the government spending fails to do much to augment productive capacity itself, the result is a net loss. If government

spending is matched by higher taxes, individual incentives could be reduced as taxpayers see the rewards for their efforts shrink.

What is remarkable about all of these possible effects of government spending increases or tax cuts is that they generally work in the same direction when it comes to the current account. That is, higher expenditures may crowd private investors out of the capital markets, possibly reducing future productive capacity. Any source of additional domestic demand reduces savings for overseas capital flows and the reduced productive capacity may limit to some extent the future ability to produce more than is consumed domestically.

In other words, what the Japanese government does matters to Americans. No matter what one believes about how fiscal policy works its way through the economy, higher Japanese spending is likely to reduce the size of the U.S. trade deficit. If this spending is accompanied by more taxes, either through growth in the economy or explicit tax increases, the effect is likely to be milder since the government would be doing less to absorb excess savings.

It is this line of thinking that prompted the group of nations signing the Louvre Accord in February 1987 to urge Japan to significantly increase government spending in fiscal 1987 (ending March 31, 1988). Overall, Japan earmarked an additional ¥4.1 trillion (\$32.8 billion at ¥125=\$1.00) for expenditures, especially on public works, and implemented an estimated ¥1.5 trillion (\$12 billion) in personal income tax cuts for calendar 1987. Partly as a result, the Japanese economy has been growing rapidly and its current account surplus has been declining.

The future looks the same, according to the Japanese government. Private and public forecasters agree that the economy will grow significantly in the fiscal year that runs from April 1, 1988 to March 31, 1989 (see JEI Report No. 8A, February 26, 1988). The government expects 3.8 percent real growth in the face of net exports cutting 1 percentage point off the rate; the average private forecast calls for 3.7 percent growth. There is also widespread agreement that the current account surplus will continue to shrink, with a government projection of \$72 billion in FY 1988 compared to an actual \$94 billion in FY 1986 and an as-yet unannounced intermediate level in FY 1987.

The Japanese Budget

Like the economic outlook, Japan's budget is developed in December of the previous calendar year and the two are closely related. To Americans, the Japanese budget process appears strikingly different. Although the opposition parties typically do not think much of what the government proposes, they are rarely able to change the budget or delay it significantly. This year the budget went into effect April 8, eight days after the start of the fiscal year in the same form in which it was presented to the Diet in January. In comparison to the American budget process, which involves numerous continuing resolutions, congressionally mandated changes and threatened (and sometimes actual) partial governmental shutdowns and the like, the Japanese process seems remarkably tidy.

If the approval process is relatively simple, the budget itself is anything but. Although the term usually refers to the general account budget, that budget accounts for less than half of total central government expenditures. The rest is in 38 special accounts earmarked for special purposes such

as the government's printing bureau. Complicating things further, some but not all the special account funds come from the general account. In addition, there are various semi-independent public organizations such as the Japan Development Bank that have their own budgets. They, too, may overlap with the general account.

Table 4 shows how these three kinds of budgets have varied in size in recent years. In total, the general account budget is a little over one-quarter of the total before subtracting the overlap. A comparison of revenues would show about the same result.

Table 4: General Account Budget, Special Accounts Budgets and Budgets of Government-Related Organizations

(initial expenditures in billions of yen)

	<u>FY 1972</u>	<u>FY 1977</u>	<u>FY 1982</u>	<u>FY 1987</u>
General Account	¥11,467.8	¥28,514.3	¥49,680.8	¥54,101.0
Special Accounts	20,510.0	56,363.7	106,942.8	149,138.0
Government-Related Organizations	8,136.5	16,552.5	23,582.1	5,276.1
Subtotal	40,114.3	101,430.5	180,205.8	208,515.1
Overlap	15,903.2	39,405.6	77,613.5	101,941.0
Net	24,211.1	62,024.9	102,592.3	106,574.1

Source: Ministry of Finance

Complicating matters still further is the Fiscal Investment and Loan Program, sometimes called the second budget. Most of its funds come from a single source, the Trust Fund Bureau Special Account, which in turn is financed mainly by postal savings. In many instances, FILP is essentially a description of how these funds are funneled into government financial institutions such as the Japan Development Bank, which in turn lends them to the public. FILP involves neither taxes nor government spending in the normal sense.

The Economic Planning Agency has to sort all this out when it develops national income statistics showing the contribution of government. It divides the government component of the gross national product into government consumption and government investment. In 1984, the most recent year such data are available, 75 percent of the central government's consumption flowed through the general account and the remainder through special accounts and government enterprises; only about 5 percent of government investment spending was attributable to the general account.

Generally speaking, then, the general account represents government consumption, and the other accounts government investment. Since EPA has found

that both government consumption and government investment are important, it suggests a need to look at more than the general account. Simply adding all the budgets together, however, would vastly overstate the fiscal thrust of government since, as noted above, they overlap. It is difficult then to infer fiscal policy from any set of budget figures. As a first approximation, most observers concentrate on the general account, with some attention to FILP, the procedure followed here.

FY 1987 Budget - The general account budget for fiscal 1987 demonstrated some of the twists and turns of Japanese fiscal policy. It was supplemented twice, making it one of postwar Japan's more complicated budgets (see Table 5). The first supplemental budget was the one that got most of the publicity. Of the Y2 trillion (\$16 billion) total, Y1.4 trillion (\$11.2 billion) went to public works and another Y0.4 trillion (\$3.2 billion) was transferred to the industrial investment special account, one of the funding sources for FILP, suggesting a substantial commitment to capital projects.

Table 5: General Account Budget, FY 1987-FY 1988

(in trillions of yen)

	<u>Initial FY 1987</u>	<u>After</u>		<u>Initial FY 1988</u>
		<u>First Supplemental</u>	<u>Second Supplemental</u>	
Budget	Y54.1	Y56.2	Y58.2	Y56.7
Bonds Issued	10.5	11.9	10.5	8.8
Bond Dependency Ratio	19.4	21.1	18.1	15.6

Source: Ministry of Finance

FY 1988 Budget - Tables 6 and 7 detail the changes for fiscal 1988. Large increases are scheduled for defense and economic cooperation, but cuts or small raises are slated for major counter-cyclical expenditures such as social security, reflecting the government's optimism about the direction of the economy. The net effect is a FY 1988 general account budget 4.8 percent larger than the initial FY 1987 budget, but 2.6 percent less than the final version. Of course, the fiscal year is still young and the current budget could be supplemented as well.

Taxes are scheduled to rise enough with the growth of the economy to allow the government to cut its dependence on deficit financing from 19.4 percent in FY 1987's initial budget to 15.6 percent this year. The figures in Table 7 reflect neither tax reform nor tax reductions, both of which are possible. Recently released data for 1987 and early 1988 suggest tax revenues in FY 1988 are likely to be higher than shown in the Table, primarily because of continuing strong economic growth and a larger-than-expected FY 1987 base on which to build. If so, the deficit to be financed with bonds will be correspondingly lower unless there is a tax cut.

Table 6: General Account Expenditures, FY 1986-FY 1988

(initial expenditures in billions of yen)

	<u>FY 1986</u>	<u>FY 1987</u>	<u>FY 1988</u>	<u>Percent Change FY 1987-FY 1988</u>
National Debt Service	Y11,319.5	Y11,333.5	Y11,512.0	1.6%
Transfers to Local Governments	10,185.0	10,184.1	10,905.6	7.1
NTT Stock Sale Proceeds to Special Account	0.0	0.0	1,300.0	n.a.
Discretionary Expenditures	32,584.0	32,583.3	32,982.1	1.2
Social Security	9,834.6	10,089.6	10,384.5	2.9
Education and Science	4,844.5	4,849.7	4,858.1	0.2
Pensions	1,850.1	1,895.6	1,879.8	-0.8
Defense	3,343.5	3,517.4	3,700.3	5.2
Public Works	6,223.3	6,082.4	6,082.4	0.0
Economic Cooperation	623.2	649.2	682.2	5.1
Small Business Assistance	205.2	197.3	195.2	-1.1
Energy Support	629.7	495.2	461.6	-6.8
Food Agency Account	596.2	540.6	448.2	-17.1
Miscellaneous	4,083.7	3,916.3	3,939.8	0.6
Reserves	350.0	350.0	350.0	0.0
Total	54,088.6	54,101.0	56,699.7	4.8

Source: Ministry of Finance

Table 7: General Account Revenues, FY 1986-FY 1988

(initial revenues in billions of yen)

	<u>FY 1986</u>	<u>FY 1987</u>	<u>FY 1988</u>	<u>Percent Change FY 1987-FY 1988</u>
Tax and Stamp Revenues	Y40,560.0	Y41,194.0	Y45,090.0	9.5%
Other Revenue Sources	2,582.6	2,406.0	1,468.7	-39.0
NTT Stock Sale Proceeds	0.0	0.0	1,300.0	n.a.
Public Bonds	10,946.0	10,501.0	8,841.0	-15.8
Total	54,088.6	54,101.0	56,699.7	4.8

Source: Ministry of Finance

FILP is scheduled for an increase of 9.4 percent over the initial level for FY 1987 (see Table 8).

Table 8: Fiscal Investment and Loan Program Outlays, FY 1987-FY 1988

(initial expenditures in billions of yen)

	<u>FY 1987</u>	<u>FY 1988</u>	<u>Percent Change</u>
Housing	Y6,328.2	Y6,921.5	9.4%
Other Social Infrastructure	3,998.7	4,450.9	11.3
Welfare	627.7	661.8	5.4
Education	784.1	637.6	-18.7
Small Business	3,985.6	4,030.6	1.1
Agriculture	907.8	979.4	7.9
Land Conservation and Disaster Work	493.0	409.8	-16.9
Roads	2,363.0	2,512.1	6.3
Transportation and Communications	2,264.1	2,229.9	-1.5
Regional Development	657.7	652.2	-0.8
Industry and Technology	630.9	687.2	8.9
Foreign Trade and Economic Cooperation	690.5	1,171.0	69.6
Self-Managed Investments*	3,350.0	4,270.0	27.5
Total	27,081.3	29,614.0	9.4

*Beginning in FY 1987 some of the sources of funds for the Trust Fund Bureau were given limited authority to manage investments themselves.

Source: Ministry of Finance

Impact of Fiscal Policy in FY 1988

Using the figures from the government's economic outlook, government spending is scheduled to increase 2.2 percent in nominal terms or 1.7 percent in real terms in FY 1988. Because of the various government budgets, and the FY 1987 supplemental budgets, these latter figures give a better indication of the actual impact of government spending on the economy than the more widely publicized increases of 4.8 percent in the general account and 9.4 percent in the FILP.

Implicit in the outlook for the current fiscal year is a diminishing role for fiscal policy. In FY 1987 EPA estimates that the public component contributed 0.6 percentage point of overall real growth, which is likely to be close to 4 percent. In FY 1988 it calculates the government contribution at 0.3 percentage point and overall inflation-adjusted growth at 3.8 percent. Clearly the outlook is assuming a surge in private demand.

Government net borrowing is likely to decrease as a percentage of GNP. The OECD estimates that the deficit will decline from 1.2 percent in calendar 1987 to 1.1 percent in 1988. Consistent with the budget figures showing a diminished reliance on bonds, this suggests the importance of expanding private

demand to either reduce savings or to absorb the surplus that would otherwise end up as capital flowing overseas. Early indications are that the government will get its wish and the private sector will in fact take up the slack.

Conclusion

Usually, but not always, the Japanese government has assigned fiscal policy a relatively small role, in keeping with the fact that the government does relatively little spending compared to other industrialized countries. In recent years Tokyo has moved successfully to restrain deficit spending, reducing the impact of fiscal policy still further. The smaller deficits have prevented government spending from absorbing much of Japan's enormous savings, which instead have gone to finance part of the U.S. budget deficit and have pushed up the bilateral trade imbalance at the same time. If the fiscal 1988 budget is any guide, little help is likely to be forthcoming in the foreseeable future in this regard from Japanese fiscal policy. It will be up to the United States to solve the problems of the twin deficits itself.

For further information, contact Douglas Ostrom.

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The views expressed in this report are those of the author and do not necessarily reflect those of the Japan Economic Institute.

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J E I

R E P O R T

A Two-Part Report: A and B

NO. 18B
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The Expansion Goes On

Japan has found itself in the unaccustomed position of collecting accolades from its trading partners for its strong economic performance. An Organization for Economic Cooperation and Development panel reports the Japanese economy is sound and that at least in the medium term its growth will continue. The statement contrasted sharply with the group's report in September 1986, which had painted a dark picture.

After hitting bottom in late 1986 or early 1987, the economy has been expanding briskly, as domestic demand-led growth pulls in more imports. In 1987 inflation-adjusted growth hit 4.2 percent (see JEI Report No. 12B, March 25, 1988), and with a third of 1988 now history, this year is already shaping up as another good one. Industrial output figures, for example, continue a pattern of strong growth, as shown in the Table below. Spending by worker households, previously something of a laggard, has shown signs of picking up. The ratio of job openings to job applications stood at a seasonally adjusted 0.90 in March,

continuing an unbroken pattern of month-to-month improvements that began last June. Department store sales rose 5.4 percent in March over the year before, roughly in line with other recent months. New automobile registrations totaled a preliminary 299,000 for March, a 12.9 percent jump compared to the year-earlier figure.

Japan's Economic Indicators

(percent change from previous period)

	<u>Industrial Output*</u>	<u>Housing Starts</u>	<u>Expenditures of Worker Households</u>
1986	0.2%	10.4%	1.4%
1987	3.0	22.7	0.8
January 1988	9.2	19.0	2.6
February 1988	12.4	17.1	5.0
March 1988	11.0**	14.8	n.a.

*Monthly industrial output data are not seasonally adjusted.

**Preliminary

Sources: Ministry of International Trade and Industry, Ministry of Construction, and Management and Coordination Agency.

At least one economic signal is flashing amber, however. The leading series of the diffusion index, broadly comparable to the leading indicators in the United States and intended to forecast short-term trends, dropped to 50.0 in February, exactly the dividing line between boom and bust and the lowest level in more than a year. It had stood at 72.7 the month before. The Economic Planning Agency cautioned against reading too much into a single month's figure. Indeed, most other indicators, such as corporate investment plans, point to continued growth.

Douglas Ostrom

Japanese Firms Move To Diversify

Nippon Kokan K.K., one of Japan's largest steel companies, is looking beyond its smokestacks. By 1990 it hopes to use biotechnology to develop new additives that will be used in a wide range of products from livestock feed to health foods. Its bigger rival, Nippon Steel Corp., is selling U.S.-made super-minicomputers in Japan and is planning to build and operate theme parks in provincial cities. So far these and similar ventures are miniscule compared to their steel operations, but the companies have high hopes that at least a few will become corporate mainstays. Some steel firms are even reported to be trying their hands at raising mushrooms and tulips.

While executives and the rank and file are reportedly said to prefer blast furnaces to gardening, the steel makers have little choice but to diversify. Along with a number of other industries they face a combination of tough

export markets arising from the high yen, and hard-charging rivals, particularly in the newly industrializing countries. As a result the steel industry is looking for opportunities where it can find them.

Japan's Fair Trade Commission has documented this trend in a study of 156 major Japanese manufacturers. As the Table shows, with few exceptions the companies are increasingly venturing outside their "home industry" in search of new business opportunities.

Share of Sales in Home Industry

(percentage in each fiscal year)

<u>Home Industry</u>	<u>FY 1979</u>	<u>FY 1984</u>	<u>FY 1986</u>
Food	96.1%	96.8%	97.0%
Textiles	66.3	60.3	57.1
Wood and Wood Products	86.1	72.8	68.8
Pulp and Paper	86.1	93.0	92.5
Printing and Publishing	99.9	100.0	88.3
Chemicals	88.4	88.7	84.6
Coal and Petroleum Products	99.2	99.7	99.2
Rubber	90.0	89.6	88.5
Nonmetallic Mineral Products	75.6	76.4	71.4
Steel	85.8	81.8	78.6
Nonferrous Metals	89.1	67.7	60.8
Fabricated Metal Products	91.5	90.9	90.0
Nonelectric Machinery	75.9	77.9	73.1
Electric Machinery	93.3	95.3	83.6
Transportation Equipment	79.4	77.0	79.0
Precision Equipment	59.1	45.1	37.6
Other Manufacturing	71.0	69.7	67.4
Average	86.7	84.5	80.2

Source: Japan Fair Trade Commission

While the trend seems to have accelerated since the appreciation of the yen that began in early 1985, it was apparent even earlier, as a comparison of FY 1979 and FY 1984 reveals. To some extent the data may overstate the actual rate of change as industrial boundaries have changed and new industries, each drawing firms from several old industries, have emerged.

The Fair Trade Commission could not be happier at these developments. It sees benefits for competition as more firms enter each industry and is convinced that diversification will speed the reallocation of resources away from declining industries. More generally, the FTC sees this corporate activity as a means toward the important objective of speeding up the structural transformation of the economy, a move in keeping with the goals outlined in the Maekawa Report. In addition, for many firms, diversification has taken the form of setting up import divisions or joint ventures with foreign companies, both of which serve to internationalize Japan's economy.

If a fair portion of these ventures prove successful, Japanese industry might live more happily with an ever-strengthening yen. Firms will realize that export markets can be replaced with revenues from either new ventures or increased importing. When demand declines in an industry, businesses will more easily shift employees to other activities.

Some veteran American observers may look at the Japanese efforts with a certain amount of *deja vu*. In the 1960s and 1970s, U.S. firms aggressively pursued opportunities in different industries, frequently by merger. The advantages of the conglomerates that resulted often proved illusory; today many are being dismembered, sometimes the victims of less-diversified Japanese rivals.

Of course Japan of the 1980s is not America of the 1970s. Most of the Japanese firms are starting new ventures, not buying existing operations, and they see their moves partly as a way of productively using their existing workforce. Often the new efforts are closer to their existing lines of business than they look at first; Nippon Kokan's biotechnology venture uses by-products of the steel smelting process, and other companies are marketing computer software they developed for internal purposes in conjunction with imported hardware. Still others use their existing marketing teams to sell the new products.

Can Japanese steel makers do a better job of running theme parks than American oil companies did at running department stores? Not everyone is convinced. Some expect that Japanese firms will increasingly resort to mergers, and become familiar with the problems of integrating ongoing operations that have often bedeviled American concerns.

A survey by the magazine *Nikkei Business* reveals some problems already. Of 809 new projects launched since 1981 by 149 firms surveyed last year, 72 percent were unprofitable or had already been abandoned. Part of the problem was that many firms identified the same areas as promising, resulting in overcrowding. Poor marketing was another difficulty.

No doubt many of the recently announced projects will fail -- the fate of many business ventures everywhere. If enough succeed, Japanese workers and management will both feel more confident about coping with rapidly changing circumstances, including successful foreign penetration of their traditional domestic markets. That is a change many Americans would welcome.

Douglas Ostrom

Japanese Investment Income Tops World

For the first time Japan's net income from dividends and interest on foreign investment in 1987 surpassed the net receipts of the United States, making Japan the world's leading investment income earner as well as top creditor. The yen's appreciation against the dollar helped Japan attain the top position but was not the main cause. The strong growth of government receipts gets credit for most of the change, although returns to private investors on direct investments and interest income also contributed a significant share.

Japan's total 1987 net investment income jumped a whopping 75.8 percent to \$16.7 billion, compared with a 30.5 percent drop in U.S. net receipts to \$14.5 billion. According to Bank of Japan data (see Table), direct investment and loan interest income showed solid growth, but only accounted for about 12 percent of the surplus. The remainder has been attributed to official government receipts related to the heavy intervention in exchange markets and loans between central banks in support of this intervention.

Japan's Investment Income, 1986-87

(in millions of dollars*)

	<u>Total</u>	<u>Direct Investment Income</u>	<u>Trade Credit Interest</u>	<u>Loan Interest</u>
<u>Credits</u>				
1986	\$29,086	\$2,670	\$2,180	\$2,294
1987	49,162	3,548	2,656	3,132
<u>Debits</u>				
1986	19,613	1,258	131	1,840
1987	32,507	1,544	710	3,099
<u>Net</u>				
1986	9,473	1,412	2,049	454
1987	16,655	2,004	1,946	33

(in millions of yen)

	<u>Total</u>	<u>Direct Investment Income</u>	<u>Trade Credit Interest</u>	<u>Loan Interest</u>
<u>Credits</u>				
1986	Y4,804,135	Y441,004	Y360,071	Y378,900
1987	7,086,211	511,515	438,692	451,540
<u>Debits</u>				
1986	3,239,479	207,784	21,637	303,913
1987	4,685,559	222,552	102,339	446,690
<u>Net</u>				
1986	1,564,655	233,220	338,433	74,987
1987	2,400,652	288,963	336,353	4,850

*The following exchange rates were used to convert the yen figures: 1986, Y165.17 and 1987, Y144.14.

Source: Bank of Japan

Another remarkable feature was the upsurge in the two-way flow of investment income. The total flow of funds in 1987 (\$81.7 billion) was 67.7 percent higher than the previous year (\$48.7 billion), a sharp departure from the modest annual growth recorded since the start of the decade. It may be a clear sign that the internationalization of the Japanese economy is taking hold.

These statistics give only part of the picture. In fact, since the Bank of Japan presents its balance of payments data in dollars, the yen's appreciation deflates the changes by 14.6 percent when viewed in yen -- 1986's exchange rate was Y165.17=\$1.00, while 1987's was Y144.14. If the figures are adjusted for this factor (using 1986's exchange rate to convert 1987 data, for example), the rise in investment income is even more impressive, bringing net receipts to Y2.8 trillion rather than Y2.4 trillion.

Although there is some disagreement in Japan as to whether the record figures represent a permanent change, economists agree that gross flows and net receipts will continue to move upward over the near term. Japan seems to be in a virtuous circle once enjoyed by the United States: increased investment leads to greater income, which again pushes up investment.

Jon Choy

Takeshita's European Trip: Setting The Stage For A Western "Triad"

Prime Minister Noboru Takeshita is progressively debunking the myth that he lacks the interest and experience to conduct a forward-looking foreign policy. In announcing plans for his 11-day European tour, April 29 through May 9, the prime minister promised to unveil an ambitious new economic assistance program as well as sow the seeds for improved relations with Europe. Mr. Takeshita indicated that he hopes to match the close ties that exist between the United States and Japan in economic, cultural, scientific and technological areas, thus forming a Western "triad." This trip, which will include visits to Italy, Britain and West Germany, will be followed by stops in France, Belgium and the Netherlands in June after the United Nations Special Assembly on Disarmament.

In a speech scheduled for May 4 in London, the prime minister is planning to lay out the "Takeshita plan" involving "greater Japanese contributions to the international community." Foreign Ministry press reports said that Mr. Takeshita will announce an increase in aid that will bring Tokyo over the 0.35 percent of gross national product averaged by the 18-member Development Assistance Committee of the Organization for Economic Cooperation and Development. (Japan's 1986 ratio was 0.29 percent.) In an interview prior to the trip, he described this plan as "in the direction" of a grand foreign aid program modeled after the Marshall Plan that rebuilt Europe. This is consistent with recent reports that Tokyo has been pulling together a comprehensive multi-year development assistance policy that will not only feature increased overall expenditures but also improve the quality of its aid.

This speech will come at a critical time in Washington as Congress considers allied defense burden-sharing. Tokyo has maintained that, given its constitutionally proscribed defense role, the aid program is an important and necessary complement to its military buildup. Officials complain that this is not fairly taken into account by U.S. legislators, who charge that Japan is

for the local labor cost allowances and benefits for some 21,000 Japanese employed at the more-than 100 U.S. military facilities in Japan. An estimated Y42 billion (\$336 million at Y125=\$1.00) is necessary to fund these expenses; Tokyo currently assumes approximately 50 percent of the local labor costs.

Under the U.S.-Japan Mutual Security Treaty, Tokyo is obliged to provide financial support for the operation of U.S. base facilities. Due in part to congressional pressure on Japan to pay more of the defense burden, Japan's fiscal 1988 defense budget includes a Y10 billion (\$80 million) increase in host nation support, bringing the total to over Y320 billion (\$2.6 billion) overall. This means that Japan will pay as much as \$45,000 per U.S. service person annually. Earlier this year, Defense Secretary Frank Carlucci applauded Japan's host nation support program, stating that Japan provides far more than any of the North Atlantic Treaty Organization allies.

Beef And Citrus - Despite five rounds of talks between April 27 and May 3, Agriculture, Forestry and Fisheries Minister Takashi Sato and U.S. Trade Representative Clayton Yeutter failed to come to terms on an arrangement eliminating Japan's import quotas on beef, oranges and orange juice. From the little the two trade negotiators said after the last meeting, the major source of disagreement was Tokyo's plan to impose a variable surcharge on beef imports after the market is open (see JEI Report No. 17B, April 29, 1988). Informed sources said the Reagan administration did not reject the surcharge proposal out of hand but did insist that the extra levy be capped and then gradually reduced. This loss of flexibility was unacceptable to Japan, however.

With the negotiations deadlocked the United States again asked the General Agreement on Tariffs and Trade to form a panel to rule on the legality of Tokyo's beef and citrus quotas. Worried that Washington might retaliate if its request was blocked a second time (see JEI Report No. 15B, April 15, 1988), Japan agreed to this action at GATT's May 4 council meeting. It will take about a month to set up the panel. Japanese trade negotiators would like to continue discussions with their American counterparts in the meantime, but the White House has given no indication whether it is prepared to do this.

Car Exports - Japan's U.S.-bound car shipments during the April 1987-March 1988 period came in 85,851 units below the 2.3 million ceiling -- the first time the industry has failed to fill its quota since shipments were limited seven years ago. While exports by company are not disclosed, analysts assume that Nissan Motor Co., Ltd. accounted for most of the shortfall since month after month of poor sales results for the number-two import seller has led to a huge stock buildup. Going by their U.S. sales and inventory numbers, Mitsubishi Motors Corp., Isuzu Motors, Ltd., Fuji Heavy Industries, Ltd. and Suzuki Motor Co., Ltd. probably did not ship their full allocations either, although their exports were off by no more than 2,000 or 3,000 units each. Mazda Motor Corp. is a closer call. But there is no question that Toyota Motor Corp. and Honda Motor Co., Ltd. filled their quotas since, unlike the competition, both companies are still able to sell every car they send to the United States.

Meanwhile, the Ministry of International Trade and Industry, contrary to early reports (see JEI Report No. 11B, March 18, 1988), has rejuggled company

quotas for the year starting April 1 to allow Daihatsu Motor Co., Ltd. to ship more cars here. The allocation for the newest Japanese marketer was upped from 11,498 units to 17,000 by trimming roughly 0.24 percent off everyone else's allotment (see Table).

Unofficial Quota Allocations, FY 1981-FY 1988

(in units)

<u>Exporter</u>	FY 1981- FY 1983	FY 1984	FY 1985- FY 1986	FY 1987	FY 1988
	<u>Quota</u>	<u>Quota</u>	<u>Quota</u>	<u>Quota</u>	<u>Quota</u>
Toyota Motor Corp.	516,659	551,792	616,900	613,816	612,350
Nissan Motor Co., Ltd.	456,030	487,040	544,500	541,778	540,500
Honda Motor Co., Ltd.	348,631	372,338	427,000	424,865	423,850
Mazda Motor Corp.	159,282	173,468	227,800	226,661	226,100
Mitsubishi Motors Corp. (including sales to Chrysler Corp.)	112,584	122,612	195,100	194,125	193,650
Isuzu Motors, Ltd. (including sales to General Motors Corp.)	16,800	49,500	120,400	119,798	119,500
Fuji Heavy Industries, Ltd.	70,014	76,250	107,600	107,062	106,800
Suzuki Motor Co., Ltd. (for sale to General Motors Corp.)	0	17,000	60,700	60,397	60,250
Daihatsu Motor Co., Ltd.	0	0	0	11,498	17,000
Total*	1,680,000	1,850,000	2,300,000	2,300,000	2,300,000

*Not included in these figures are the separate quotas on exports of four-wheel-drive vehicles, station wagons and mini vans and on shipments to Puerto Rico. These quotas are estimated at 112,900 units and 95,700 units, respectively, for the FY 1985-FY 1988 period.

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The views expressed in this report are those of the authors and do not necessarily represent those of the Japan Economic Institute.

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A Two-Part Report: A and B

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SHARING THE DEFENSE BURDEN WITH JAPAN: HOW MUCH IS ENOUGH?

Summary

During the past decade dramatic international changes have substantially expanded U.S. security activities and commitments. At the same time trade and budget deficits have escalated, forcing the Pentagon to restrain the increase in spending. As Washington feels the stress of coping with increased defense needs, policymakers have begun to call on U.S. allies to assume more of the financial burden for the defense of the Western alliance.

Japan's huge trade surplus and low defense spending have brought it tough criticism for enjoying a "free ride" on security from the United States. It has been the repeated target of legislation and exhortations demanding that it spend significantly more to support mutual security interests in the Asian Pacific. Unfortunately, most critics have examined Japan's defense efforts through a lens distorted by anger and frustration over chronic trade frictions. This has made it difficult to objectively assess Japan's security requirements, the steps Tokyo has taken over the years to improve and expand its defense capabilities and, in turn, consider what the United States can reasonably ask its most important Asian ally to do given Japan's domestic political and legal constraints.

Defense Burden-Sharing: Congress Grows Restive

In December 1987 the House Armed Services Committee established the Defense Burden-Sharing Panel to examine the costs and benefits of U.S. global

defense commitments. According to chair Patricia Schroeder (D, Colo.), the group is motivated by the strong sense that the United States can no longer police the world and build a strong and stable economy. Since "the towering trade and budget deficits have forced a new period of fiscal restraint on the United States," she said in convening the hearings February 2, 1988, "we can no longer shoulder the burden of defending our NATO [North Atlantic Treaty Organization] allies and Japan without a greater commitment from them for their own defense. Our future security rests in a growing domestic economy and competitiveness in international markets."

Defense Department official Dennis E. Klose observed last spring that Congress is "making a direct link between burden-sharing or the lack of burden-sharing and the trade deficit and [is] fed up with it." Indeed, during the past year legislators have responded with a flurry of proposals not seen on Capitol Hill since the late 1960s when Washington was saddled with the mounting costs of the Vietnam War. These measures include:

- A resolution calling on Japan to spend 3 percent of its gross national product on defense (up from the current 1.004 percent), which was adopted by both the House and Senate;
- Several proposals calling for troop reductions in Europe and Japan unless U.S. allies increase their annual defense spending;
- An amendment to the fiscal 1988 and 1989 defense authorization bills urging negotiations to increase the share of GNP spent on defense by U.S. allies;
- A Japan-targeted amendment to the fiscal 1988 defense authorization bill suggesting increased development assistance programs and defense spending to make Japan's ratio of outlays to GNP roughly equal to those of other NATO members.
- An amendment to the fiscal 1988 State Department authorization bill calling on U.S. allies to share on a pro-rata basis the costs of defending oil shipments through the Persian Gulf; and
- A "defense protection fee" requiring allies to pay a duty on all products they ship to this country equivalent to the share of GNP that the United States spends on defense, minus the percent they spend on defense.

Why the push this year? Congressional sources suggest a confluence of factors. First and foremost is growing frustration with the continuing high trade deficit and related economic problems. However, the U.S.-Soviet accord on eliminating intermediate-range nuclear missiles in Europe has also lent additional impetus to this debate. If the INF agreement is ratified by the Senate, NATO countries will have to re-evaluate the adequacy of their conventional forces and decide who will shoulder the majority of costs for improvements -- a responsibility that legislators feel the United States can no longer fully assume if it is to get a handle on its fiscal and other economic problems.

The October 1987 stock market crash, too, has affected the policymaking atmosphere, intensifying concerns that economic vulnerability may prove to be as great a threat to U.S. security interests as Soviet military capabilities. Finally, this is an election year, which traditionally features some sort of "guns versus butter" debate.

Defense burden-sharing is not without considerable legislative background, however. The Vietnam War spawned similar troop reduction proposals and a variety of legislative initiatives aimed at getting the allies to "help us out." But it appears that more recent history has propelled the current debate. Momentum has been steadily building since the late 1970s when policymakers were jolted by the costly security implications of the Iranian revolution, the Soviet invasion of Afghanistan and other signs of regional instability. These concerns were reflected in the fiscal 1981 defense authorization bill, in which legislators declared that,

the burdens of mutual defense by the countries allied with the United States [under NATO and the U.S.-Japan security treaties] are not commensurate with their economic resources and the continued unwillingness of those countries to increase their contributions to the common defense to more appropriate levels would endanger the vitality, effectiveness and cohesiveness of the alliances between those countries and the United States.

More importantly, the bill introduced a novel means of prodding U.S. allies to increase their defense outlays: an annual assessment of their contributions based on economic strength called the "Report on Allied Contributions to the Common Defense." Unfortunately, the report, which is prepared and submitted to Congress each year by the Department of Defense, has not been particularly well received on Capitol Hill. While the Pentagon adheres to the letter of the law, Congress charges that the assessment is so balanced that it is useless in the effort to put political pressure on NATO and Japan to increase military spending. Thus legislators have felt compelled to undertake their own examination of the issue since this enables them to draw from a variety of sources that do not necessarily have a vested interest in maintaining and managing current defense relationships.

To date the burden-sharing panel has heard from witnesses as diverse as former Defense Secretary Harold Brown, Richard Barnet of the Institute for Policy Studies, George Bader, principal director of Europe and NATO policy for the Defense Department, former Senate Armed Services Committee chairman John Tower and Kazuyuki Hamada of the Center for Strategic and International Studies. In addition to producing a report on the proceedings, the panel may develop legislation to give their conclusions and policy recommendations the force of law. If nothing else, the group's activities will keep the subject on the front burner in 1988.

Japan's Defense Effort: Turning Up The Heat

Administration Approach - As part of this revitalized effort, both the administration and Congress have singled out Japan's defense spending for special scrutiny. It is important to recall that during the first two decades of the postwar period, the United States strongly supported Tokyo's decision to emphasize economic recovery over defense needs. Since Japan's emergence as a

major economic power in the late 1960s and early 1970s, however, Washington has periodically pressed Tokyo to make a greater contribution to common security interests.

The administration's more recent calls for increased Japanese defense spending have been motivated primarily by strategic concerns. The expansion of Soviet military strength in the Far East has significantly changed the security climate, requiring better developed Japanese defense capabilities. Rather than arguing over numbers, however, the administration has focused on defense "roles and missions," an approach that encourages certain expenditures to fulfill mutually acceptable defense goals. When Washington initially broached this subject with Tokyo in early 1981, it emphasized the following ground rules:

- The United States would continue to provide a credible nuclear deterrent as well as an offensive strike force in the Northwest Pacific;

- Japan should strengthen its defense forces to assume primary responsibility for the security of its territory, coastal waters and airspace, as well as to protect economically vital sealanes out to approximately 1,000 nautical miles to the south and east;

- The United States would maintain its security commitment to the Republic of Korea and protect sealanes beyond the Northwest Pacific critical to Japan's security (e.g. oil routes).¹

This policy was formalized in a June 1981 joint communique signed by President Reagan and then-Prime Minister Zenko Suzuki. In a subsequent National Press Club appearance, Mr. Suzuki confirmed that it would be Japan's national policy to assume the "mission" of defending the seas and skies surrounding Japan as well as the sealanes out to 1,000 miles from its Pacific ports. (Previously, its sealane security extended only to a 200-mile radius.)

The statement was significant for two reasons: first, it was a clear articulation of Japan's defense goals. But second, and perhaps more importantly, it has given some direction to Japan's defense buildup. Japan's 1976 National Defense Program Outline stipulates that Japan should possess the "minimum necessary level" of defense forces to deal with "limited and small-scale aggression." Through successive five-year procurement programs, known as the Mid-Term Defense Plans, the Japan Defense Agency has sought to meet this vaguely defined defense capability goal. According to James Auer, the Defense Secretary's special assistant for Japan, "bilateral negotiations since 1981 have been aimed at trying to get Japan to achieve the defense capabilities to enable it to meet the goals set forth by Mr. Suzuki [that year]."

Another important characteristic of the administration's policy has been to separate security from trade and other economic issues. According to Mr. Auer, this linkage "simply doesn't make sense. Some have argued that Japan should increase defense spending because it runs a huge trade surplus with the United States, rather than saying that Japan should increase its defense capabilities because of the Soviet threat to Japanese and U.S. security interests. [Japan's] defense budget has a rationale of its own based on an assessment of external threats, not on its trade balance with the United States," he maintains.

¹Gregg Rubinstein, "U.S.-Japan Security Relations," The Fletcher Forum, Vol. 12, No. 1, Winter 1988, p. 43.

Nonetheless, as defense analysts have observed, attempts to isolate defense from other aspects of U.S.-Japan relations are increasingly at odds with political realities.² Although the administration deplores this linkage, it cannot be denied that congressional cries for defense spending increases have provided useful bargaining leverage for U.S. negotiators pressing Tokyo for greater expenditures to meet expanded "roles and missions." Too, this policy may be repeatedly challenged in the years to come as the two countries engage in more cooperative high technology ventures.

Congressional Approach - Unlike the executive branch, Congress has been trying for 20 years to forge this link (see JEI Report No. 35A, September 18, 1987). This approach has more appeal to constituents, particularly if they have lost jobs because of Japanese competition. Essentially, legislators note the huge bilateral trade deficit and related competitiveness problems and conclude that Japan has taken the "savings" from its "free ride" under the U.S. security umbrella and channeled it into commercial success -- to the detriment of American industry and workers. Accordingly, they say, Tokyo should use more of its wealth for defense, which would enable this country to regain its competitive edge. It is implied that increased defense spending will hurt Japan economically and brake the trade juggernaut.

This argument is flawed in several respects. First, as Mr. Auer and other Pentagon officials have repeatedly pointed out, it does not take into account how Soviet activities in the Asian Pacific might affect U.S. and Japanese security needs. Second, there is no clear-cut evidence to substantiate the contention that greater defense spending would hurt Japan's business and trade performance, and help ours. A plethora of other factors affect economic conditions and competitiveness (fiscal and monetary policies, microeconomic factors such as corporate strategies, and so on).

Third, this argument implies that as Japan spends more on defense, the United States will be able to cut back. Gregg Rubinstein of Grumman International, Inc. notes that defense cooperation is not a zero-sum game between the United States and Japan. "The issue is one of complementarity rather than substitution," he contends. "The point is that U.S. resources [will also be] needed for U.S. tasks. Both countries [will have] to [continue to] do more to meet their responsibilities."

Finally, the linkage argument does not stipulate exactly how greater Japanese defense monies should be spent. Should Japan earmark trillions of yen for defense if it does not have the missions that would be necessary to justify it? What would the money buy? Wouldn't such a dramatic increase in defense allocations cause grave concerns among Japan's Asian neighbors worried about revived militarism?

Nevertheless, this view of the situation underlies virtually all of Congress' burden-sharing initiatives. And as the trade deficit and bilateral sectoral disputes have increased, the rhetoric has grown harsher, focusing more on defense spending as a percentage of GNP or on imposing defense-related trade sanctions. In this respect it can be argued that Japan is now paying the price for past policies. Until last year Tokyo was adamant that defense spending not exceed 1 percent of GNP rather than allowing security needs to determine the size of the budget. This focus has in effect helped to cast the congressional debate in percent-of-GNP terms.

²Ibid., p. 50.

This is not to say that there are not more moderate views on Capitol Hill. Sen. Carl Levin (D, Mich.), for one, has abandoned the linkage argument in favor of the administration's "roles and missions" approach. Although acknowledging his frustration with the disparity between bilateral trade and defense relations -- "it seems as though the larger the trade deficit we have with a trading partner, the smaller the defense burden being carried by that country" -- he also cautions that "we shouldn't mix apples and oranges Troop reductions [and other initiatives] should be based on national security, not on prosecuting a trade war."

Senate Majority Leader Robert Byrd (D, W.Va.) has also advocated a policy approach closer to the administration's. In 1986 Sen. Byrd urged the Japan Defense Agency to pursue policies that would meet the Suzuki goals and to consider spending any savings realized by the appreciation of the yen or lower oil prices to cover more of the costs of Japanese civilians at U.S. military bases in Japan -- a policy recently adopted. The previous year he successfully sponsored an amendment to the fiscal 1986 State Department authorization bill requiring the Pentagon to include in its annual burden-sharing report an analysis of Japan's performance toward achieving adequate defense capabilities out to 1,000 nautical miles.

Sen. John Rockefeller (D, W.Va.), too, feels that Japan should match its global economic success with commensurate political responsibilities, but says that "we should not neglect to note the important strides that have been made [in Japan's defense buildup] in the last several years nor ignore the realistic limits of what can be accomplished in the future." Sens. Rockefeller, Levin and Byrd are in a decided minority, however; particularly if trade frictions continue to escalate, they may be unable to refocus the debate.

Overview of Japan's Defense Program

Critics who focus on Japan's defense spending as a percent of GNP and on that basis conclude that it is apathetic about defense often overlook important facts. The past five years have seen steady, quantitative increases in overall defense spending, although from a very small base. The defense budget has increased approximately 6 percent annually since FY 1983 to become the sixth-largest military budget in the world. In addition, Japan now deploys more tactical aircraft than U.S. forces in all of Asia and it has almost twice as many destroyers as the U.S. Seventh Fleet. Qualitative improvements in weapons systems and armed forces training have also proceeded. These military measures have been complemented by an economic assistance program that is the second-largest in the world.

Japan's current defense capabilities provide a base-line level that is useful in assessing what more can and should be asked of it.

The 1986-90 Mid-Term Defense Plan: Procurement - This is the third such program undertaken to meet the goals set forth in the 1976 National Defense Program Outline. It generally focuses on improving and expanding Japan's capabilities in air defense, anti-submarine warfare, ground force response to a manned invasion, and command, communications, intelligence and reconnaissance.

It calls for acquisitions of military systems including: 50 P-30 anti-submarine warfare patrol aircraft; 63 F-15 fighters; seven C-130 transport aircraft; six Patriot surface-to-air missile systems to replace outdated Nike missiles; nine destroyers; and five submarines (see Chart 1). In addition, by

Chart 1

Attainment of Defense Buildup Under National Defense Program Outline

Classification	Outline	Fiscal 1987	Program Completion
SDF Personnel	180,000	180,000	180,000
GSDF			
<i>Units deployed regionally:</i>			
Divisions	12	12	12
Composite brigades	2	2	2
<i>Mobile operation units:</i>			
Armored division	1	1	1
Artillery brigade	1	1	1
Airborne brigade	1	1	1
Training brigade	1	1	1
Helicopter brigade	1	1	1
<i>Low altitude surface-to-air missile units:</i>			
Anti-aircraft artillery groups	8	8	8
MSDF			
<i>Anti-submarine surface-ship units (for mobile operations):</i>			
Escort flotillas	4	4	4
<i>Anti-submarine surface-ship units (regional district units):</i>			
Divisions	10	10	10
<i>Submarine units:</i>			
Divisions	6	6	6
<i>Minesweeping units:</i>			
Flotillas	2	2	2
<i>Land-based anti-submarine aircraft units:</i>			
Squadrons	16	14	16
<i>Main Equipment:</i>			
Anti-submarine surface-ships	60	61	62
Submarines	16	14	16
Combat aircraft	220	168	214
ASDF			
<i>Aircraft control and warning units</i>	28	28	28
<i>Interceptor units:</i>			
Flight squadrons	10	10	10
<i>Support fighter units:</i>			
Flight squadrons	3	3	3
<i>Air reconnaissance units:</i>			
Flight squadrons	1	1	1
<i>Air transport units:</i>			
Flight squadrons	3	3	3
<i>Early warning units:</i>			
Flight squadron	1	1	1
<i>High-altitude surface-to-air missile units:</i>			
Anti-aircraft groups	6	6	6
<i>Main equipment:</i>			
Combat aircraft	430	396	415

Source: Japan Defense Agency

planning for the deployment of SSM-1 surface-to-surface missiles, a domestically designed and manufactured system capable of striking a ground object at a distance of 62 miles, Japanese forces should be able to intercept a potential invasion force well before the time it actually reaches the home islands.

A noteworthy feature of the fiscal 1987 budget, which funded the second year of this estimated ¥18.4 trillion (\$147.2 billion at ¥125=\$1.00) program, was the funding for an over-the-horizon radar site for defense against long-range Soviet Backfire bombers. Defense analysts termed the decision a "turning point" because it represented the first time that a weapon was bought that was not strictly for Japan's self-defense. The radar will function as part of a proposed chain of stations from Alaska through the Aleutian Islands to the Philippines.

DOD believes that completion of this plan by 1990 should enable Japan to defend its sealanes out to 1,000 nautical miles. The Japan Defense Agency maintains that its fiscal 1988 budget, at ¥3.7 trillion (\$29.6 billion), should adequately fund major front-line equipment purchases, including the next-generation fighter support aircraft (the FSX), and enable Japan to meet these mid-term procurement goals.

Host Nation Support - Under the U.S.-Japan Mutual Security Treaty, Japan provides base facilities for U.S. forces. The bases not only represent the U.S. commitment to Japan's security but they are also critical to U.S. deployments in the Asian Pacific arena. Tokyo provides 40 percent of the \$6 billion costs of maintaining U.S. forces at over 100 military facilities, and presently funds 50 percent of the local labor cost allowances and benefits for 21,300 Japanese employees; 100 percent of these labor costs will be funded in 1990.³ Moreover, its fiscal 1988 defense budget earmarks over ¥320 billion (\$2.6 billion) for 55,000 U.S. personnel, which amounts to more than \$46,500 per person. As one defense analyst observes: "[Congressional] critics who have advocated the withdrawal of U.S. forces from Japan over trade problems and Japan's perceived free ride on defense would do well to consider this Japanese support for the U.S. [Far East] strategy."⁴

Joint Planning and Maneuvers - A marked increase in joint military exercises and strategic planning has enhanced the ability of the two countries' armed forces to operate together. The 1978 "Guidelines for U.S.-Japan Defense Cooperation" set the stage for regular planning discussions to consider joint action in meeting a threat to Japan. In January 1988 Defense Secretary Frank Carlucci and Japan Defense Agency head Tsutomu Kawara agreed to commission a joint study on the logistics of deploying heavily equipped U.S. combat troops to Japan in the event of an invasion. The planning process itself has been of tremendous value in providing each side with a more realistic perception of the other's capabilities.⁵

³Testimony of Admiral Ronald J. Hays before the Senate Armed Services Committee, March 15, 1988, and testimony of Assistant Secretary of Defense Richard L. Armitage before the House Appropriations Subcommittee on Military Construction, March 16, 1988.

⁴Rubinstein, op. cit., p. 44.

⁵Ibid., p. 45.

Joint military training is also on the rise. Although initially these exercises were limited in scope, usually involving only the Maritime Self Defense Forces in maneuvers with the U.S. Navy, all branches of the Self Defense Forces now participate in joint training exercises with U.S. forces. Since 1986 the two have sponsored combined exercises involving all branches of the armed services (see Chart 2). Recently JDA announced that approximately 10 warships, nine anti-submarine planes and about 2,300 troops will participate in the U.S. Pacific Fleet's biannual RIMPAC maneuvers around Hawaii in June and July -- the largest participation by the Japanese Navy since it joined this exercise in 1980.

Chart 2

Participants at U.S.-Japan Combined Military Exercises, 1986		
	Japan	U.S.
Joint Staff Councils	6,000	7,000
GSDF	3,660	3,790
MSDF	334-v	241-v
ASDF	1,227-a	931-a
v = vessels a = aircraft		
Source: Japan Defense Agency		

Defense Co-Production and Technology Transfers - For 30 years the United States has been the primary supplier of Japan's defense materiel. Together, government, commercial sales and licensed production programs amount to approximately \$1 billion annually. These include the E-2C early-warning radar aircraft, the Harpoon anti-ship missile, the Phalanx anti-missile cannon, and -- although Congress almost quashed the sale because of doubts about Japan's ability to safeguard defense technology -- the \$1 billion Aegis naval air defense system. Co-production programs currently under way include the F-15 fighter aircraft, P-3C patrol aircraft and a number of air defense missiles.

Although these arrangements have generally proved quite profitable for U.S. industry (Japan's longstanding policy barring weapons exports has meant that the trade balance in this sector is 100 percent in this country's favor), the co-production program has often been criticized as a "technology grab" (see JEI Report No. 19A, May 14, 1982). Japan, too, has become restive, complaining that these programs leave it dependent on the United States for sophisticated military technology. This concern as well as security needs have created considerable domestic pressure to forego these arrangements in favor of developing indigenous defense systems.

However, both State and Defense have repeatedly stressed that co-production, whatever its inefficiencies, still presents the best compromise

between U.S. and Japanese economic and security interests. It has enabled Japan to acquire a degree of self-sufficiency while at the same time promoting systems interoperability and keeping lucrative sales channels open.

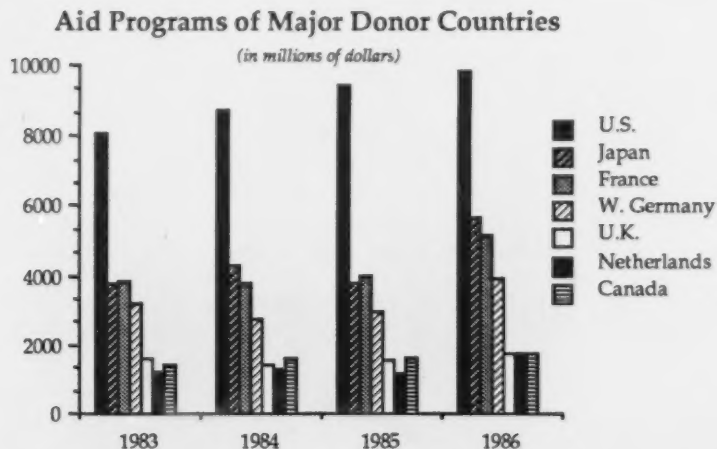
Similarly, given Japan's technological prowess, bilateral military technology exchanges could be one of the most mutually beneficial aspects of U.S.-Japan defense relations -- if bureaucratic and political problems can be overcome. Until recently the technology flow has been primarily one way -- from the United States to Japan. In 1983, however, the two sides concluded an agreement to transfer Japanese military technology to the United States. Tokyo and Washington have had problems with the arrangements because of concerns about "giving away" military technology that will be spun off into commercial avenues.

However, Japan's participation in the Strategic Defense Initiative and the plan for joint development of the FSX are positive signs that the 1983 agreement may bear fruit. Washington wants the FSX project to succeed not only so that Japan has aircraft capable of deterring the Soviet threat but also to establish a standard for meaningful joint weapons systems development farther down the road. Although it would appear that Congress indirectly strong-armed Japan into foregoing the development of an indigenous fighter in favor of working with General Dynamics Corp., the fact remains that Tokyo did place bilateral interests above narrow national concerns.

Overseas Development Assistance - Since the early 1980s when Prime Minister Masayoshi Ohira introduced the concept of "comprehensive security," Japan has included aid as part of its defense equation. According to Japan's interpretation of its peace constitution, it is prohibited from acquiring an offensive capability or engaging in collective security arrangements. Thus Tokyo relies on economic assistance to reinforce global security.

Although in the sixties and seventies Japan's official development assistance was largely targeted toward its Southeast Asian neighbors and tied to purchases of its goods, there has been a decided shift in that approach. Japan now ranks second in the world, behind the United States, in terms of overall aid disbursements (see Chart 3). And on paper virtually all of this

Chart 3



Source: Organization for Economic Cooperation and Development

assistance is now untied; however, Tokyo's "request only" approach to disbursing aid has resulted in a certain amount of de facto tied aid (see JEI Report No. 41A, October 30, 1987).

In response to U.S. pressure, the geographic focus has also been broadened to include several countries of strategic interest to the United States, such as the Philippines, Turkey, Pakistan and Egypt. In 1985 Tokyo announced that it planned to disburse more than \$40 billion in the 1986-90 period, and to double 1985's \$3.8 billion ODA figure by 1990. Perhaps even more significant was the decision last year to recycle approximately \$20 billion of its current account surplus into the developing countries over a three-year period (see JEI Report No. 41A, October 30, 1987).

In the face of this effort, Japanese observers criticize the congressional burden-sharing panel for not considering non-military contributions to security.⁶ Still, the fact that Tokyo's ODA budget as a percent of GNP is still comparatively low at 0.3 percent has been a lightning rod for criticism that it can and should be doing even more, despite the fact that the \$5.5 billion earmarked for ODA in fiscal 1988 is hardly a nominal amount.

Domestic Factors - Japan's enormous strides in developing its defense capabilities would not have been possible had there not been solid public support for the buildup. And there is little doubt that this opinion has been strongly affected by the marked increase in Soviet military activities in the region. Some critics suggest that one reason Japan does not feel compelled to expand its defense effort is because it does not view the Soviet threat as seriously as does the United States. That is not the case. If anything, many in the Japanese government have a more critical view of Soviet intentions in this part of the world as a result of incidents such as the Northern Territories dispute, the KAL 007 tragedy and repeated seizures of Japanese fishing vessels.

Last month, in fact, the maritime forces strengthened aerial surveillance of Soviet naval maneuvers around Hokkaido, where the Soviet military presence now includes nuclear-powered attack submarines and other sophisticated warships. JDA fears that Moscow is trying to turn the northern Pacific into a sanctuary for its nuclear submarine fleet. Similarly, the ground forces earlier this year adopted a new forward defense strategy against a possible Soviet invasion of northern Hokkaido, emphasizing firepower to deter an invasion at the shoreline rather than relying on the inland defense system. The government's acute awareness of the nature and extent of Moscow's military presence in its backyard is apparent in a reading of Chart 4 in the annual defense report.

Currently 60 to 70 percent of the population support Japan's defense role within the context of the U.S.-Japan Mutual Security Treaty. This is a very significant shift from the 20-year period after the occupation, when any government policy that appeared to exceed the limits of Article 9 of the constitution met with public outcry. (Article 9 says that Japan will forever

⁶Testimony of Kazuki Hamada of the Center for Strategic and International Studies before the House Armed Services Subcommittee on Burden-Sharing, April 19, 1988.

renounce war and the "threat or use of force as a means of settling international disputes.") Even the opposition Japan Socialist Party has swung around to the view that the self defense forces, while still "unconstitutional," are nevertheless "legal." These contradictory semantics have helped lend further legitimacy to the entire Japanese defense structure.

Chart 4

Soviet Forces in the Far East		
Classification	1976	1987
Intermediate-range nuclear forces	SS-20=0	SS-20=170
	TU-22M	TU-22M
	Backfire=0	Backfire=85
Ground forces	Divisions=31	Divisions=43
	Troops=300,000	Troops=390,000
Naval forces	Vessels=755	Vessels=840
	Tonnage=1.25 million	Tonnage=185 million
Air forces	Combat aircraft=2,030	Combat aircraft=2,390
Source: Japan Defense Agency		

Nevertheless, the Japanese and their Asian neighbors are still squeamish about upping the ante. This was apparent when Prime Minister Yasuhiro Nakasone shepherded through a fiscal 1987 defense budget that exceeded the 1 percent of GNP limit. (It amounted to 1.004 percent of GNP.) As a government source described it, when the budget safely stayed within the 1 percent benchmark, no one questioned how the money was being spent; as soon as the limit was passed, the opposition, the public and Asian countries expressed alarm about revived militarism. A poll of the ASEAN (Association of Southeast Asian Nations) countries conducted by the Foreign Ministry in February 1987 noted that there had been virtually no change in opinion since 1983 on the question of whether Japan would become a "threatening military power" if encouraged to assume a greater defense role. These political sentiments have influenced and will continue to influence the government's consideration of an expanded defense role.

A Forward-Looking Approach? - Recent statements and policies suggest that Tokyo is adopting a more creative approach to expanding its defense role in an effort to respond to Washington's requests while at the same time remaining sensitive to domestic and regional attitudes. Last summer, then-Prime Minister Nakasone took the very bold step of indicating that Article 9 of the constitution would not proscribe Japan from sending minesweepers to the Persian

Gulf. No military action was taken, however. Tokyo instead promised to make certain non-military contributions, including a sophisticated land-based navigation system to facilitate the passage of ships, increased ODA to strategic countries like Oman and Jordan, financial support to the United Nations peace-keeping operations and increased host nation support. Still, the initiative was significant because it indicated a willingness to break from a literal interpretation of the constitution in the interests of allied cooperation.

In a March 21 speech to the graduating class of the National Defense Academy, Prime Minister Noboru Takeshita also appeared to strike out in a new direction, urging the development of defense capabilities "commensurate with our national [economic] power." On the eve of his May trip to Europe, he promised to spell out a plan for "greater Japanese contributions to the international community" involving increased ODA and greater support for U.N. peace-keeping activities. According to both U.S. and Japanese sources, these statements by no means presage a major military buildup. Rather, they indicate a willingness and desire on the part of the government to explore non-military means to shoulder more of the security burden as well as carry out those defense missions that have been defined in the 1986-90 plan.

There does appear to be a more progressive approach to military planning and procurement, however. Some items under discussion for the 1991-95 plan include over-the-horizon radar, AWACs and tankers for Japan's air force -- qualitative improvements to enhance the anti-submarine and air defense network called for in the current mid-term plan. Also under study is the acquisition of a small aircraft carrier for the maritime forces, which has sparked considerable debate. Because there is opposition to Japan's acquiring an offensive power projection capability, experts give it only a 50-50 chance of being included in the 1991-95 plan. There are indications that the Pentagon may also be worried about giving Japan a more autonomous capability that could complicate joint planning and maneuvers. However, JDA officials justify the acquisition on the grounds that it will be used for strictly defensive submarine warfare, and is essential to maintain an effective air defense out to 1,000 nautical miles.

JDA and Defense officials have also agreed to store military supplies in Japan for use by American forces in deployment exercises. Although this has been a longstanding practice with NATO allies, this is the first time Tokyo has agreed to it.

How Much Is Enough?

There are areas where Japan can do more. Increasing strategically targeted, untied ODA to 1 to 2 percent of GNP would certainly be a significant and welcome step. However, budgetary constraints may undermine efforts in this direction. In fact, the Foreign Ministry does not foresee a quantum leap in ODA; only continued, gradual increases.

This being the case, Japan may have to lay its reservations to rest and plunge into defense technology transfers and joint development projects. There is a recognition that all parties involved will reap the benefits of these arrangements in both the military and commercial spheres. Tokyo's willingness to take responsible positions on difficult international issues, such as the

Iran trade embargo, would enhance its image in the United States and further deflect burden-sharing criticism.⁷

Japan's defense program has been described as composed of "small steps forward, with no backtracking." Unfortunately, the pressure of the trade deficit has made Congress impatient with incrementalism. At the same time, behind some of the harsh rhetoric is an awareness that ally-bashing can be counterproductive on an issue as complicated and politically sensitive as this one. On April 29 the House soundly defeated two amendments to the fiscal 1989 defense authorization bill that would have required sharp troop withdrawals from NATO countries and Japan unless their defense spending increased by a rate equal to their economic growth, or expanded to approximately 6 percent of GNP -- the U.S. level. With the defeats, however, came warnings from both supporters and opponents alike that this issue would definitely return in the next administration. "It's clear that a reappraisal of our defense burden is long overdue," said Rep. Andy Ireland (R, Fla.), co-chair of the burden-sharing panel with Rep. Schroeder, who voted against the amendments.

By and large U.S.-Japan defense relations have been, as described by one Pentagon official, the "success story of the 1980s." But unless Tokyo can continue to demonstrate its commitment through aid, foreign policy or other initiatives, the security aspect of the relationship could get sucked into the trade quagmire.

⁷Statement of Sen. John Rockefeller before the U.S. Senate, December 17, 1987.

For further information, contact Barbara Wanner.

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The views expressed in this report are those of the author and do not necessarily represent those of the Japan Economic Institute.

5/20/88

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J A P A N · E C O N O M I C · I N S T I T U T E

JEI

R E P O R T

A Two-Part Report: A and B

NO. 19B
May 13, 1988

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Tax Panels Submit Reports

A major reform of Japan's tax system took another step forward April 28 when the government and Liberal Democratic Party tax advisory bodies submitted recommendations to Prime Minister Noboru Takeshita. While both call for the introduction of a new indirect tax, the two reports differ on its form. Both recommend significant tax reductions for individuals and corporations as well as a more equal distribution of the tax burden. Despite the harmony between the government and the ruling party, Diet passage of a tax reform package remains uncertain.

Although the general contents of the government Tax System Council's report were leaked April 22, the report was not formally handed to the prime minister for six days. The delay was needed to iron out some details and to

tax panel, government officials, opposition parties and businessmen began April 10 to establish the exact rate of the indirect tax. The commission hopes to have this point clarified by May 20, when it will move on to the tax's form. The government and LDP hope to conclude talks by the end of June in preparation for convening a special Diet session in July.

Prime Minister Takeshita is clearly trying to avoid the trap that caught his predecessor by working to get a national consensus on the indirect tax. The opposition remains opposed to the new levy, but the general mood of the nation is that it is inevitable. While Mr. Takeshita has had his way on nearly every tax proposal so far, many obstacles lie in the path to tax reform.

Jon Choy

Japan's Payments Surplus Inches Down

The process may seem painfully slow, but Japan continues to make progress in whittling down its huge balance of payments surplus. In the January-March 1988 quarter the trade imbalance was down 9 percent in dollar terms and the current account surplus dropped 11.8 percent, the fourth straight quarter of year-to-year declines (see Table 1). Both figures, however, are still substantially above the levels recorded two years ago.

Table 1: Japan's Balance of Payments

(in millions of dollars)

	<u>Trade Balance</u>	<u>Exports (f.o.b.)</u>	<u>Imports (f.o.b.)</u>	<u>Services (net)</u>	<u>Current Account Balance</u>	<u>Long-Term Capital (net)</u>
1983	\$31,454	\$145,468	\$114,014	\$-9,106	\$20,799	\$-17,700
1984	44,257	168,290	124,033	-7,747	35,003	-49,651
1985	55,986	174,015	118,029	-5,165	49,169	-64,542
1986	92,827	205,591	112,764	-4,932	85,845	-131,461
1987 (p)	96,464	224,432	127,968	-6,099	86,688	-137,127
1986:I	14,552	44,813	30,261	-1,145	12,668	-18,990
1986:II	23,922	52,270	28,348	-374	23,099	-28,882
1986:III	26,793	53,859	27,066	-1,922	24,413	-38,410
1986:IV	27,560	54,649	27,089	-1,491	25,665	-45,179
1987:I	23,373	50,515	27,142	-1,348	20,962	-32,209
1987:II	25,038	55,823	30,785	-1,601	22,762	-44,365
1987:III	23,585	56,600	32,015	-1,757	21,189	-22,023
1987:IV (p)	24,468	61,494	37,026	-1,393	21,775	-38,530
1988:I (p)	21,268	59,299	38,031	-1,500	18,487	-15,305

Source: Bank of Japan

For fiscal 1987 (ended March 31), Japan registered a current account surplus of \$84.5 billion, the first decline -- albeit a modest one -- in six years. The fiscal 1986 figure was \$94.1 billion. The trade surplus came in at \$94.3 billion in FY 1987, down from \$101.6 billion.

In the latest quarter imports continued to lead the way, rising a whopping 40.1 percent from a year earlier in dollar terms. Even yen-denominated purchases rose 17.1 percent. Exports were up in terms of dollars but almost flat in yen, a pattern also evident in the customs-clearance trade data released earlier (see JEI Report No. 16B, April 22, 1988).

The most dramatic year-to-year change was in the long-term capital account. The figures for the first quarter suggest that investor sentiment is changing: the net outflow for the quarter was the smallest since the first quarter of 1985, more than compensating for the somewhat lower current account surplus. (The figures in Table 1 refer to net long-term capital inflows to Japan by foreigners minus net long-term outflows of Japanese capital to the rest of the world, not just to the United States, although this country accounts for a sizable chunk. Japanese investment overseas substantially exceeds foreign investment in Japan.)

Wall Street has kept a wary eye on Japanese investors, worried that life insurance companies and others will cut their losses from the dollar's drop against the yen and withdraw or at least stop adding to their holdings of American securities. Japanese participation in overseas bond and stock markets is shown in Table 2. Bond holdings grew slowly in the first quarter, with net purchases in all foreign markets down 43 percent from a year earlier while Japanese investors were actually net sellers of stock on overseas markets.

Table 2: Japan's Net Purchases of Foreign Securities

(in millions of dollars)

	Bonds			Stocks		
	Purchases	Sales	Net	Purchases	Sales	Net
1983	\$22,905	\$10,400	\$12,505	\$2,106	\$1,445	\$661
1984	56,348	29,575	26,773	1,570	1,519	51
1985	291,338	237,859	53,479	5,484	4,489	995
1986	1,346,989	1,253,965	93,024	20,917	13,869	7,048
1987 (p)	1,273,829	1,200,944	72,885	70,936	54,062	16,874
1986:I	251,591	234,330	17,261	2,793	1,961	832
1986:II	368,271	343,467	24,804	3,717	2,260	1,457
1986:III	357,331	330,980	26,351	6,481	4,473	2,008
1986:IV	369,796	345,188	24,608	7,926	5,175	2,751
1987:I	377,850	354,648	23,202	13,925	9,386	4,539
1987:II	341,880	316,585	25,295	15,277	9,797	5,480
1987:III	325,517	308,421	17,096	21,882	18,370	3,512
1988:IV (p)	228,582	221,290	16,509	19,852	16,509	3,343
1988:I (p)	332,047	318,877	13,170	18,901	19,466	-566

Source: Ministry of Finance

However, gauging the intentions of Japanese investors from changes in net capital flows may yield an exaggerated picture. The largest quarter-to-quarter swing factor in international equity and bond investment was not Japanese. Foreigners had been selling their stock holdings in Japan for seven straight quarters, a movement that peaked in the last quarter of 1987 when they unloaded a net \$21.5 billion in Japanese equities. Apparently attracted by the strength of the Tokyo stock market after Black Monday, American and other investors rushed back in earlier this year, purchasing a net \$5.9 billion worth of stock in the first quarter, an all-time high. Since foreign investment in Japan reduces net capital outflows, this \$27.4 billion swing was in the same direction but substantially larger than the quarter-to-quarter reduction in net Japanese purchases of stocks and bonds shown in Table 2. Together they contributed to the smaller net long-term capital outflow shown in Table 1.

If the trends hold up, it could mean future pressure on the dollar, both from Japanese investors buying fewer dollars for bond and equity investments and Americans and others supplying more dollars to the market as they acquire yen to buy Japanese equities. Central banks would then either have to pick up the difference or let the dollar fall. While shrouded in secrecy and statistical imprecision, burgeoning foreign exchange reserves in the face of declining private capital outflows indicate the Bank of Japan may already be trying to offset the actions of American, Japanese and other investors.

Douglas Ostrom

Takeshita Elaborates Foreign Policy Goals

In a May 4 speech in London, Prime Minister Noboru Takeshita presented the much ballyhooed "International Cooperation Initiative," a three-part plan involving Japanese support for international peace initiatives, greater cultural exchanges between Japan and other countries and expanded official development assistance. Mr. Takeshita said the three-part initiative constituted the "main pillar" of his foreign policy and pledged to work with his European counterparts to usher in a "new era in Japanese-European relations."

For a prime minister considered less interested in international affairs than his predecessor, this address -- and in fact his entire European tour (see JEI Report No. 18B, May 6, 1988) -- appears to indicate that Mr. Takeshita wants to leave his imprint on Japan's foreign policy and act as a global leader in his own right. "I believe that it is Japan's responsibility as a major industrialized democracy to play a positive role commensurate with its increased national strength to maintain peace in the world and to secure the prosperity of the international community," he said. This conviction prompted British Prime Minister Margaret Thatcher to remark that not only was a closer Japan-Europe relationship welcome, but that Britain intended to encourage further Japanese investment based on the sound record that Japanese firms have established so far.

The main thrust of Mr. Takeshita's meetings with British, Italian and West German leaders concerned trade matters. As expected, Mrs. Thatcher pressed the prime minister to lift Tokyo's tax on imported liquor and wine. Mr. Takeshita reportedly said that Japan is planning to revise the liquor tax as part of its comprehensive tax reform effort, but Mrs. Thatcher argued for a

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J E I

R E P O R T

A Two-Part Report: A and B

NO. 20A

MAY 20, 1988

JAPAN'S ROLE IN MULTILATERAL AID ORGANIZATIONS

Summary

As Japan's economic stature continues to grow, so too do its contributions to multilateral aid agencies. Tokyo has been steadily increasing its financial assistance to these organizations but has been content to take a back seat to Washington in formulating policies. Despite its low profile, however, Tokyo has begun to demand some recognition for its financial commitments -- primarily in the form of increased voting power in the multilateral banks. The United States has thus far been unwilling to relinquish its influence in these organizations. This report will explore Japan's role in the multilateral aid agencies, the pressures on Tokyo to expand its financial and political influence, and the effect of these multilateral policies on the U.S.-Japan relationship.

Introduction

Japan's global economic influence has fueled foreign demands that Tokyo shoulder more of the responsibility for international stability. While U.S. burden-sharing demands are familiar to Japanese officials, there is a growing clamor from the developing countries for more assistance to enhance their economic wellbeing. Tokyo, for its part, is quite willing to acknowledge the "international responsibilities of a surplus nation" and has consistently pledged to play a more active role in this area.

The question is how -- and how much? Tokyo has three major options. First, significant increases in defense spending, including contributions to U.S. military support in Asia. Officials argue that although efforts are being made on this score, they are limited by public opinion, constitutional con-

straints and the concerns of other Asian countries over any substantial military buildup by Japan (see JEI Report No. 19A, May 13, 1988). Second, Japan could help stabilize the international economy by embracing a number of trade liberalization schemes. The appreciation of the yen has helped somewhat in this regard, having spurred the Japanese market for foreign imports. But again, although Tokyo continues to participate in bilateral and multilateral trade negotiations, the domestic political ramifications involved make moderation the preferred course -- especially in very sensitive sectors such as agriculture.

The third option is economic development assistance for third world countries. This is the principal option that Tokyo has chosen. By assisting the development goals of these countries Japan also helps to achieve conditions that benefit the economies of the industrialized countries: expanded markets, an improved investment climate, the increased likelihood that debtor countries will meet at least some of their obligations and -- by extension -- greater political stability for regimes that promote market-oriented solutions. To these ends Japan has been steadily increasing its official development assistance and has made a number of efforts to stimulate Japanese private sector initiatives in less developed countries.

The spotlight on Japan's efforts has led to questions regarding the best way to achieve these goals. Both Tokyo and Washington would argue that in an ideal world the problems would be solved exclusively by private sector initiatives. In fact, however, the private sector is reluctant to expose itself further to the risks of political instability, nationalization and debtor defaults. Thus attention is focused primarily on government efforts.

Bilateral or Multilateral Aid?

Should Japan channel its financial contributions into bilateral or multilateral economic assistance? Each has advantages. The major attraction of bilateral aid is the control that Japan retains over disbursements. Aid becomes a valuable political tool -- one that Japan has used very effectively in Asia. Moreover, bilateral aid can be disbursed more quickly and more flexibly since it escapes some of the built-in red tape of the multilateral lending agencies.

The list outlining the advantages of multilateral assistance is longer. For one thing the political value of bilateral aid is a mixed blessing. From a purely economic standpoint, mixing politics and aid does not provide an optimal distribution of aid monies. What is more politically relevant, however, is that multilateral aid is less vulnerable to criticism from other countries and that contributions to multilateral organizations, which are a reflection of international economic strength, lend a certain prestige to the donor nation. Indeed, the Ministry of Foreign Affairs has lauded the "neutrality" of multilateral assistance, noting that "it makes recipient countries less apprehensive about [being subject to] a specific country's influence."

The ministry is also convinced that multilateral assistance is more likely to result in policy reform than Japan's bilateral aid. Although Tokyo

supports the linkage between policy reform and aid, the structure of its bilateral program makes it nearly impossible to insist on this linkage. Japan's aid program has a number of built-in safeguards to protect the sovereignty of the recipient country. The most effective of these is the "request-only" policy, which stipulates that all aid projects must be requested by the recipient government; Japanese aid officials cannot prescribe the specific use of the aid funds (see JEI Report No. 41A, October 30, 1987).

Moreover, the ministry acknowledges that international organizations often have better access to information and more expertise than individual governments. This is an important consideration since Japan has few experts who are knowledgeable about Latin America, sub-Saharan Africa and the Middle East. This poses a major problem for Tokyo; although it has pledged to improve the geographic distribution of its aid flows -- roughly 65 percent of total aid goes to Asia -- it lacks the facilities and personnel in other regions to do so effectively. Multilateral organizations, on the other hand, have the expertise and the resources to handle larger and more complex projects than an individual donor country.

Table 1

DAC Members' Multilateral ODA Contributions

	Percent of ODA <u>1985-86 average</u>	Percent of GNP <u>1985-86 average</u>	Percent of DAC multilateral ODA <u>1985-86 average</u>
Australia	30.3%	0.14%	3.0%
Austria	29.1	0.08	0.9
Belgium	19.8 (35.5)	0.10 (0.18)	1.3
Canada	38.3	0.19	8.6
Denmark	41.2 (47.9)	0.35 (0.41)	3.1
Finland	39.7	0.17	1.4
France	10.8 (18.4)	0.08 (0.14)	6.6
Germany	18.8 (31.7)	0.08 (0.14)	8.6
Ireland	25.5 (56.9)	0.07 (0.15)	0.2
Italy	23.6 (35.2)	0.08 (0.12)	5.6
Japan	32.1	0.09	20.4
Netherlands	24.3 (32.5)	0.24 (0.31)	4.7
New Zealand	20.3	0.06	0.2
Norway	41.1	0.46	3.8
Sweden	29.7	0.25	3.9
Switzerland	23.8	0.07	1.1
United Kingdom	23.4 (42.6)	0.08 (0.14)	5.2
United States	16.8	0.04	21.4
Total DAC	22.5 (27.2)	0.08 (0.10)	100.0

Note: Figures in parentheses include contributions from the European Economic Community.

Source: Organization for Economic Cooperation and Development, Development Cooperation, 1987 Report (Table IX-5). Reprinted with permission.

Japan's Contributions to Multilateral Aid Institutions

Partly for these reasons Japan's multilateral contributions as a percentage of total ODA have been higher than the average among members of the Development Assistance Committee of the Organization for Economic Cooperation and Development. (Multilateral aid takes two major forms: grants from Tokyo to the United Nations and its related organizations; and grants and loans to international financial institutions such as the World Bank, International Monetary Fund and regional lending institutions.) Japan's 1985-86 average was 32.1 percent -- substantially above the 22.5 percent DAC average -- and lower only than the shares of Denmark, Norway, Finland and Canada (see Table 1 on previous page).

Japan's latest aid initiative -- a three-year plan to recycle \$30 billion of Japan's current account surplus to the developing world -- includes a healthy portion of multilateral assistance. The first \$10 billion goes exclusively to multilateral aid institutions. The remaining \$20 billion includes bilateral loans, private loans that are co-financed by the World Bank and additional contributions to multilateral organizations. A more detailed breakdown follows:

\$10 Billion to Multilateral Development Institutions

- \$2.6 billion - FY 1988-90 subscriptions to the International Development Agency (the low-interest arm of the World Bank).
- \$3.6 billion - (3 billion in Special Drawing Rights) for the International Monetary Fund as a special facility to deal with unusually critical situations that require "financial support beyond the usual recourse."
- \$2 billion - Special fund for the World Bank: \$200 million in grant money from Japan and \$1.8 billion to be raised by the World Bank in Tokyo's capital market.
- \$1.3 billion - Funds for the Asian Development Foundation (a window of the Asian Development Bank).

\$20 Billion Recycling Initiative

- \$8 billion - Further government contributions to multilateral lending agencies, including the World Bank, the Inter-American Development Bank, the Asian Development Bank and the African Development Bank.
- \$9 billion - Untied loans by the Overseas Economic Cooperation Fund, the Export-Import Bank of Japan and possibly private banks co-financed by the World Bank.
- \$3 billion - Export-Import Bank untied loans.

Approximately 60 percent of the funds are reserved for multilateral contributions. Some of this may be because Tokyo's aid program suffers from an image problem among other DAC countries. Many critics regard Japan's bilateral assistance as little more than a way for Japanese industry to win lucrative

contracts in the developing countries. Princeton University professor John Lewis summed up this view: "The Japanese bilateral program, to say the least, has not been among the more self-denying in [regard to satisfying commercial self-interests]."

Officially, Tokyo's record is quite good when it comes to tied aid. OECD statistics show that Japan's use of tied aid is lower than the United States'. But the structure of the aid program causes some problems. Because Tokyo requires detailed feasibility studies before it approves an aid project, the recipients often turn to Japanese businesses for help in designing the proposal. By the time the study is completed, its specifications often fit quite closely with the goods and services offered by Japanese firms, leading to charges that Tokyo endorses an informal tying of aid to economic procurement.

Foreign critics also collide with Tokyo on the type of projects chosen. In 1986 more than 45 percent of bilateral assistance was earmarked for capital-intensive projects in public utilities, industrial, mining and construction. The DAC singled Tokyo out for criticism on this score during its annual talks last December, pointing out that these types of projects often depend on foreign supplies of sophisticated equipment.

Tokyo's multilateral efforts do not completely escape attack. Critics charge that Japan exaggerates its contributions. They point out, for example, that the \$10 billion portion was announced a year before the total package was unveiled. Similarly, they charge that the \$2 billion that is to be raised in Japan's capital markets imposes no burden on Tokyo and should not be claimed as a bona fide "contribution." Nonetheless the attacks on multilateral aid are much less strident than those on bilateral programs. The tone is also quite different. Most foreign aid specialists seem quite satisfied with the effectiveness of multilateral donations; their only complaint is that Tokyo should do more.

Japan's Potential

Japan's aid program has enormous potential for expansion -- especially in the area of multilateral assistance. For one thing, Japan's financial resources are staggering, with a current account surplus of almost \$87 billion in 1987. The sheer size of its surplus qualifies Japan as the most likely donor of funds for the third world. The most serious obstacle is that the surplus is in the private sector, while the government has been operating under tight financial constraints. This is one reason Tokyo has encouraged the private sector to cooperate with the World Bank in co-financing new developing country loans.

Expanded contributions to the multilateral agencies are a way for Tokyo to maintain a fair amount of international credibility, since bilateral initiatives tend to be regarded with more suspicion. But this poses a different problem for Japan. The size of a country's capital subscription to a multilateral lending institutions is reflected in its voting share. Any increase in one country's voting share necessarily implies a proportional cut in another donor's; in this case the most likely candidate for a decrease is the United States. Although Tokyo was given an increased vote in the World Bank recently, Washington has been extremely reluctant to concede its influence in the World Bank or any other lending institution.

Japan has been able to skirt the issue somewhat by establishing "special funds" in the global and regional lending banks, but it is not likely to be satisfied with this state of events for long. A nation's voting share is a mark of international prestige; Japanese aid officials are facing domestic pressure from the Diet to demand a more equitable distribution of power in exchange for increased financial commitments. Some government officials also want Tokyo to exert more influence over the allocation of multilateral aid funds. Ministry of Finance officials reportedly want to see more loans to India and China; the Foreign Affairs Ministry tends to have a more global view.

Political Leadership

At the same time there is a growing clamor for Japan to take a leadership role in the multilateral banks. The pressure is coming from a number of sources: other DAC countries, the international press, policy analysts, and Japanese internationalists -- especially in the aid community -- who are dissatisfied with Tokyo's reluctance to propose significant initiatives. Few specific suggestions have been made regarding the policies Japan should take; the general impression seems to be merely that Tokyo should do more. The glaring exception to this list is Washington, which is turning the screws in the opposition direction. U.S. officials are quite content with the status quo since the firm U.S.-Japan alliance in the banks allows Washington to retain its traditional political influence.

One suggestion that has cropped up repeatedly in the press is the appointment of a Japanese head of the International Monetary Fund or the World Bank. This appears unlikely at least for the immediate future, especially since there is little enthusiasm for the idea in Japan. According to the Journal of Commerce, Finance Minister Kiichi Miyazawa said in 1986 that there are no Japanese officials qualified for the job.

Perhaps a better way to describe the situation is that those Japanese who are qualified for the job are not likely to accept. For government officials there is more opportunity for professional advancement at home; for businessmen, long-term prospects for success are brighter if they remain with their companies. Traditionally, Tokyo has been quite content to follow Washington's political lead in matters relating to development and its participation in the development institutions has been a way of emphasizing U.S.-Japan policy coordination and soothing other areas of conflict, such as trade disputes.

At first glance Tokyo's reluctance to assume a more vigorous leadership role appears at odds with its desire for a larger voting share in the lending institutions. But it is a question of prestige; assuming a greater share would not affect Japan's alliance with the U.S. on most policy issues. This is a great source of frustration to non-U.S. officials in the lending banks. One official, for example, complained that Japan has simply bought itself an important position in the World Bank. It would be more productive, he said, if Tokyo showed more interest in policymaking and was willing to actively oppose some U.S. positions.

For its part Japan has pledged to act in a manner consistent with its economic status and has proposed a few initiatives, although these have been

either noncontroversial or extremely general. The former are no threat to Washington's leadership; the latter leave ample room for U.S. input. Still, the fact that Tokyo has taken the first step is a positive development and may portend a more active leadership role in the future.

The World Bank and the International Monetary Fund

Japan's position in the World Bank is a classic example of its commanding financial presence and low-key policy approach. Its voting share -- second only to the United States' -- was increased in 1986 when Tokyo agreed to raise its contributions to the International Development Agency by some \$350 million in return for an increase of 1.5 percentage points in voting power. The United States agreed to relinquish part of its 20 percent share on condition that it retain its veto power. Japan's total IDA contribution, \$2.6 billion, is included in the \$30 billion in aid discussed above.

Japan's position in the International Monetary Fund is not quite as powerful as in the World Bank. According to the Fund's 1986 annual report, Japan's voting share is 4.57 percent, putting it in fifth place after the United States, the United Kingdom, Germany and France. One official said that Japan has a more difficult time being heard in the IMF than in the World Bank and that this is illustrated by the fact that Tokyo ranks relatively lower in the size of its voting share.

Despite its low-profile approach, Tokyo has used the annual IBRD-IMF meetings as a forum to announce aid initiatives. The increase in Japan's IDA subscription was one example, as was the announcement of a \$500 million grant package for the poorest developing countries, especially those in sub-Saharan Africa. The package was intended to complement the \$20 billion recycling fund which is targeted at middle-income developing countries. In 1987 Tokyo suggested the establishment of a debt-equity conversion fund to be administered by the International Finance Corporation.

Tokyo again raised the debt problem at the April 1988 annual meetings. Finance Minister Kiichi Miyazawa rejected short-term solutions involving debt forgiveness or debt reduction, advocating instead a long-term perspective that would enable countries to embrace a cooperative solution. The details were kept vague; he merely asked that member countries study the problem and propose an appropriate initiative. U.S. cooperation would be necessary for such a plan to succeed, however, and Washington has thus far resisted the idea of a multilateral debt scheme.

But for the most part Japan supports U.S. policies, such as those linking multilateral disbursements to policy adjustments and reforms in the LDCs. According to the 1987 DAC Report, the "countries which, in recent statements of their general policy priorities and objectives, have given particular emphasis to policy reform include Canada, Germany, Japan, the Netherlands, the United Kingdom and the United States." As one would expect, the way that Tokyo has demonstrated its support for this concept is through financial contributions. The DAC points to Japan's multi-million-dollar contribution for a Special Facility for sub-Saharan Africa administered by the IDA.

Asian Development Bank

If there is one institution in which Japan has taken a dominant role it is the Asian Development Bank. Tokyo is the largest contributor and also holds the formal reins of power, since the president of the bank has traditionally been Japanese. But here, too, Tokyo is more than willing to see Washington play a strong co-leadership role. The U.S. subscription and voting share is only slightly less than Japan's. Washington contributes 14.8 percent compared with Tokyo's 15 percent. Policymaking, therefore, has been shared fairly equally.

As Dennis Yasutomo points out in Japan and the Asian Development Bank, Tokyo has been plagued by an apparent contradiction regarding its image in the bank. One the one hand, it is the bank's nominal leader. Moreover, its relationship with Washington is more collaborative than concessional. On the other hand, Tokyo is reluctant to become too dominant, partly because it fears resurrecting memories of the wartime Greater East Asia Co-Prosperity Sphere in the developing countries and partly to preserve amicable relations with Washington, which wants to retain its influence.

Yasutomo quotes one Finance Ministry official on this question:

Japan has been replacing the role the U.S. has been playing, but we don't want to be very dominant in the ADB. Among ASEAN [nations], India and Pakistan, there is a feeling that Japan is too dominant in the region. We want to be less conspicuous. We want the United States and Australia to join with us to be the three major forces. But because of U.S. unwillingness to shoulder the burden, we are forced to come up with [more] contributions.

One negative byproduct of this conflict -- combined with other obstacles such as language difficulties -- is that Japanese officials are reluctant to play an active political role within the ADB. This has resulted in a passivity and a tendency to allow other countries to have a disproportionate input in policy decisions.

Still, because Tokyo has been pumping more money into the ADB, officials are anxious to receive some recognition for their contributions. Consequently the question of voting shares and capital contributions has surfaced. Finance Ministry official Toyoo Gyohten said during the April 1988 annual meeting of the ADB that "Japan is ready to shoulder the responsibility as the largest financial contributor on condition that the United States agrees to the capital hike." Bank of Japan governor Satoshi Sumita argued that a steady flow of funds is necessary to counteract setbacks such as natural disasters, economic changes in developed countries and changing commodity prices. But U.S. officials have said that there will be no need to consider an increase until the early 1990s.

Tokyo claims that it deserves a larger voice on the basis of its financial contributions -- including a special fund set up specifically for the ADB under its \$30 billion initiative. While several member countries agree, not all are convinced that a capital hike is the most relevant issue to discuss.

Swedish aid officials, for example, stress that discussions of a capital increase are meaningless if there is no consensus on the goals and policies of the bank. This issue is bound to become more prominent as U.S. financial constraints prompt Tokyo to assume an ever-larger financial presence.

The United Nations

In 1986 (see JEI Report No. 18A, May 9, 1986) Japan provided \$75.9 million for the U.N.'s regular budget, the third-largest amount after the United States and the Soviet Union. Japan has been a top donor to several U.N. programs as well, including the World Health Organization, the United Nations Development Program, the World Food Program, the United Nations Children's Fund and the United Nations High Commissioner for Refugees (see Table 2).

Table 2

DAC Members' Shares in ODA, IDA and Selected Categories of U.N. Funding

(in percentages)

	ODA 1985-86	IDA-8	UNDP 1986-87	UNFPA & UNICEF 1986-87	Extra-Budgetary Contributions to UN Agencies 1985-86
Australia	2.3%	2.0%	1.1%	0.6%	1.7%
Austria	0.7	0.7	1.1	0.3	0.7
Belgium	1.5	1.7	2.1	0.5	3.9
Canada	5.1	4.9	6.4	5.4	2.1
Denmark	1.7	1.3	7.9	4.7	11.4
Finland	0.8	0.8	2.7	5.8	3.0
France	13.7	7.2	4.8	1.5	2.3
Germany	10.2	11.8	8.2	7.3	6.3
Ireland	0.2	0.1	0.2	0.2	---
Italy	5.1	6.0	6.4	7.4	14.7
Japan	14.1	22.3	8.8	14.4	8.2
Netherlands	4.3	4.3	8.9	8.1	12.6
New Zealand	0.2	0.1	0.2	0.2	---
Norway	2.1	1.4	7.9	10.6	9.3
Sweden	2.9	2.6	9.0	10.7	11.6
Switzerland	1.1	1.4	3.8	3.2	4.5
United Kingdom	5.0	6.7	4.3	4.6	2.1
United States	29.0	24.7	16.1	14.4	5.7
Total DAC	100.0	100.0	100.0	100.0	100.0

Note: ODA: Official Development Assistance
 IDA-8: Eighth replenishment of the International Development Agency
 UNDP: United Nations Development Program
 UNFPA: United Nations Fund for Population Activities
 UNICEF: United Nations Children's Fund

Source: Organization for Economic Cooperation and Development, Development Cooperation, 1987 (Table IX-6). Reprinted with permission.

The political circumstances in the United Nations are quite different from those in the multilateral banks. The General Assembly operates on a one-country, one-vote basis. This means that the industrialized countries are vastly outnumbered by the developing nations. North-South tensions have been extremely pronounced in the U.N. because the LDCs have the voting clout to push measures through the General Assembly. As a consequence, Tokyo has found it much more difficult to vote with the consensus in the U.N. While it has tended to support U.S. positions, Washington has been in the minority more often than not, forcing Tokyo to tread a fine line on North-South issues as it attempts to back U.S. positions without alienating the developing countries.

Japan has opted for a risk-averse strategy by maintaining a very low profile and espousing vague rather than clearly defined policies. While it has not made many enemies this way neither has it established a definitive leadership role. The Far Eastern Economic Review quoted one American official as explaining, "If your aim is to be a key player, then you have to act according to an international definition of a key player. Otherwise nobody takes you seriously." (Although a Japanese official was recently appointed director of the World Health Organization, this is an exception rather than the rule.) One of the most frustrating issues for Africans has been Tokyo's unwillingness to force Japanese business firms to further reduce the extent of their trade relations with South Africa (see JEI Report No. 7B, February 19, 1988). African nations resent Japan's policies on apartheid, and as a result Japan's relations with the region have suffered.

This has already begun to jeopardize Japan's position on the U.N. Security Council. Although it is not a permanent member, Japan has been elected to the Security Council as a temporary member more often than any other country. There are reports, however, that Tokyo is finding it more and more difficult to muster the requisite two-thirds majority for election. Many of the defectors are African nations. More generally, however, observers point to Tokyo's reluctance to take the lead in formulating positions and policy recommendations. In short -- as in other multilateral organizations -- Japan's financial stature outweighs its political leadership.

Development Assistance Committee

The Development Assistance Committee of the OECD is not a multilateral lending institution, but it is a forum that Japan takes very seriously. One of the standards by which various aspects of Japan's ODA contributions are measured is the DAC average. Aid as a percentage of GNP, for example, is an area in which Tokyo has not compared favorably with other donor countries. In 1986 the group averaged 0.36 percent, compared with Japan's 0.29 percent. When Japanese officials discuss aid goals they often refer to Tokyo's intention to raise its ODA/GNP ratio to at least the DAC average.

On the reverse side, the DAC recognizes Japan as one of the largest ODA donors. Tokyo's contributions have grown enormously in recent years, catapulting Japan to second place on the donor list. Furthermore, most observers are predicting that Tokyo will surpass the United States as the number-one donor in the next year or two. The growth of Japan's ODA program can be attributed to two major factors. First, Tokyo has made ODA a major priority and established a series of aid-doubling programs to stress the importance of steadily increasing its contributions (see JEI Report No. 41A, October 30, 1988). Second, the increase in the value of the yen has caused the dollar value of aid disbursements -- the currency used for DAC statistics -- to soar.

The DAC's annual reports praise Japan for the level of its overall aid commitments. Specifically with regard to multilateral aid, the 1986 report said that Tokyo has increased its contributions "to a degree which calls into question the traditional balance of influence, as reflected in voting rights and which resuscitates, in a new form, the thorny question of burden-sharing." The report highlighted the importance of a "second rank of donors" after the United States, referring to Canada, Germany and Japan. Although Germany and Japan have been less vocal in proposing initiatives, the report said, "the sheer size of their contributions inevitably gives considerable weight to whatever positions they take."

Conclusion

There is little doubt that Japan's role in the multilateral aid organizations will continue to grow in importance. In financial terms alone its participation is vital to the World Bank and the Asian Development Bank. Even non-Asian regional banks, such as the Inter-American Development Bank and the African Development Bank, rely on Japan as the second most important donor.

The future of Tokyo's political leadership is more doubtful. There has been little evidence of a willingness to take the lead in devising innovative multilateral responses to debt and development problems. Although the proposals announced at the IBRD/IMF annual meetings suggest some movement toward a leadership role, they are still too small to be significant.

Much of the reason for the inaction revolves around the United States. For one thing Washington is extremely unwilling to relinquish its overwhelming influence. In the World Bank, for example, the United States is the only member with veto power. Tokyo quite simply has no desire to challenge Washington on this score. Moreover, some World Bank officials believe that Japan views its role in multilateral organizations more as an extension of its relationship with Washington than in a global context. One official complained, "If [World Bank president] Barber Conable asked Tokyo to do something, the answer might be no. If [U.S. Treasury Secretary] James Baker made the same request, the answer would be yes."

While this might be an exaggeration, it is true that Tokyo's role in the multilateral institutions is intimately connected to its relationship with Washington. Still, the decline in the U.S. financial position relative to Japan gives the leadership question more urgency. The external pressures on Japan to increase its financial contributions are especially intense; it is here that the largest changes are likely in the near future. (Unless some accommodation is made in relative voting shares, however, funding will probably continue to take the form of "special facilities.") The pressures to take the lead in policymaking are more muted at this point -- Washington certainly has no desire to see such a change -- but still very real.

For further information contact Eileen M. Doherty.

The views expressed in this report are those of the author and do not necessarily represent those of the Japan Economic Institute.

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JEI

R E P O R T

A Two-Part Report: A and B

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Takeshita Faces Thorny Domestic, International Policy Issues

Prime Minister Noboru Takeshita returned home after a successful diplomatic foray in Europe to a host of domestic and international policy issues that are testing his political mettle. Heading the agenda is the highly contentious beef and citrus quota dispute with the United States. In the domestic policy area, Mr. Takeshita must also try and shepherd through the Diet a comprehensive tax reform bill. Finally, the prime minister has had to contend with the negative repercussions of a cabinet member's comments defending Japan's wartime activities in Asia. Although it is too soon to tell how his management of these issues will affect his tenure as prime minister, most would agree that Mr. Takeshita is at an important point in his administration and must effectively demonstrate that he has both the diplomatic skills and the political savvy to navigate Japan through rough waters.

The prime minister has said that he favors resolving the beef and citrus dispute through bilateral negotiations. After the April 27-May 3 talks stalled, Washington again asked the General Agreement on Tariffs and Trade to form a panel to rule on the legality of the quotas (see JEI Report No. 18B, May 6, 1988). Since it will probably take until early to mid-June for the GATT to

while the Koreans have expanded capacity by 240 percent in 12 years. While it would be reasonable for the EC to ask Japan to reduce its capacity to match the European cut, no specific numbers have been raised.

On April 23 Tokyo agreed to a five point accord: the two sides concur that the grave situation in world shipbuilding requires special attention; both governments will cooperate on the "common objective of urgently improving the market situation" with particular attention to restoring prices to profitable levels; regular meetings on implementation will be held; other shipbuilding countries, especially Korea and Finland, will be invited to join the talks; and Tokyo will gradually bring its export credits to shipbuilders in line with world levels.

The results may be moot in view of recent announcements that Japanese shipbuilders plan to merge operations and reduce capacity. Of the two dozen major firms, eight groups will remain at the end of this year, with capacity reductions ranging from 13 to 26 percent. According to Transport Ministry calculations, the capacity of these firms will drop from 3.1 million gross tons to 2.4 million gross tons by the end of fiscal 1988 (April 1, 1989). The key to the global market problem, however, is persuading Seoul to restrain growth -- an unlikely prospect.

- Access to public works projects - Just before Mr. Takeshita left for the continent, the EC issued a joint communique demanding that Tokyo give European construction firms the same consideration as U.S. firms in bidding on specific public works projects (see JEI Report No. 14B, April 8, 1988). The April 25 document reiterates the community's longstanding position calling for a "balance of benefits" in Japan-U.S.-EC relations and warns Tokyo and Washington that the EC will not hesitate to take action if the two discriminate against European companies. At the same time the community pledged to actively encourage domestic firms to pursue Japanese bids. The prime minister did not touch on this subject, but officials reiterated Tokyo's position that the special bidding procedures would be applied equally to all interested foreign firms.

- Modifications to the U.S.-Japan semiconductor accord - The last issue, modifying the U.S.-Japan semiconductor accord to comply with a ruling by the General Agreement on Tariffs and Trade, is in the midst of a negotiation hiatus. The initial round of talks between Tokyo, Washington and Geneva gave each side a chance to clarify its positions (see JEI Report No. 19B, May 13, 1988), but little else was achieved. Tokyo is hard at work trying to tread a narrow path between the U.S. and EC positions, and hopes to hold a second round of talks this summer. If the process holds true to form, Tokyo will find a formula that will keep trade issues from poisoning overall bilateral relations.

Jon Choy

Japanese Workers Win Bigger Paychecks

Although Japan's labor unions termed this year's annual spring wage negotiations (shunto) the "13th consecutive defeat" at the hands of management, unionized workers will take home paychecks that average 4.38 percent more, higher than last year's 3.5 percent increase. The unions' gloom reflects

dashed expectations of higher increases based on the economy's solid recovery from last year's high-yen "recession." Most analysts expect this year's gain in basic pay levels to support, not spur, consumer spending. Since the data are based on a mid-term survey, however, this picture may yet change.

According to an April 27 poll by Nihon Keizai Shimbun, workers at 1,310 companies won an average ¥10,162 (\$81.30 at ¥125=\$1.00) increase-based on calculations adjusted for relative employment in each industry (see Table), bringing average base monthly compensation to ¥231,750 (\$1,854). Of the industries listed, it is interesting to note that only four show wage hikes below the 4.38 percent average. The impact of these industries on the overall average may be exaggerated, however, because they constitute a large share of the number of firms surveyed (47.3 percent). Indeed, when an average based only on the number of firms is calculated, the figure falls to 4.3 percent.

Mid-Term Results of the 1988 Spring Wage Negotiations

(as of April 27, in yen and percent)

Industry	1987 (Actual)		1988		Monthly Wage	Average Worker Age (years)	Number of Firms
	Amount	Change	Amount	Change			
Communications	¥10,359	4.51%	¥12,874	5.37%	¥238,129	36.6	41
Leisure	9,262	4.05	11,763	5.03	232,723	34.3	77
Retailing	8,055	3.99	10,368	5.01	205,133	30.1	48
Information, Software	10,502	4.26	12,307	5.00	243,699	32.4	36
Electronics	7,439	3.59	9,801	4.58	213,534	33.2	90
Real Estate	8,850	3.66	11,011	4.49	247,624	36.8	125
Machine Tools	7,859	3.43	10,446	4.47	232,900	34.4	184
Securities	7,440	3.90	8,700	4.46	195,226	26.4	2
Distribution, Transport, other services	8,259	3.46	10,800	4.41	244,982	37.9	88
Food, Pharma- ceuticals	8,234	3.54	10,021	4.22	238,207	34.9	125
Automotive	6,940	3.25	9,106	4.16	218,936	34.4	114
Energy, Metals, Chemicals, Raw Materials	6,987	3.01	8,975	3.83	235,415	35.6	280
Aerospace, Engineering	5,821	2.48	7,824	32.8	239,535	38.8	100
Average	7,936	3.50	10,162	4.38	231,750	35.2	1,310

Source: Nihon Keizai Shimbun, May 4, 1988.

Nevertheless, the survey is a good indicator of the relative health of the various industries. It is clear that workers in service industries enjoyed

significantly larger pay raises than their counterparts in manufacturing firms, with communications, leisure, retailing, and software and information services leading the way. At the other end of the spectrum, steel and shipbuilding workers eked out 1.7 and 2.7 percent pay raises, respectively. While the service sector has indeed been enjoying strong growth, corporate profits for industry as a whole were up 19.3 percent in fiscal 1987 and manufacturing firms showed an even higher average gain of 24.7 percent.

Coupled with a solid outlook for overall economic growth and a falling unemployment rate, labor had hoped for an average 6 to 7 percent increase. Industry leaders responded by reiterating last year's position that wage increases only fuel inflation, and that the best path to increased real income is to lower prices for goods, services and housing through deregulation and tax reform. The 1988 shunto was the first test for the recently formed Japan Private-Sector Trade Union Conference, or Rengo, which represents 5.6 million workers. Hoping for an average 6 percent increase, Rengo's leadership called this year's talks a "harsh trial" but claimed above-average results anyway. That management was able to hold the line reveals the true relative strength of business and labor in Japan.

With overall inflation running around 1 percent, opinion is divided as to the impact on consumption of the 3.4 percent real wage increase. Pointing to solid growth in consumer spending, some analysts predict an overheating, pushing up the consumer price index by as much as 1.5 percent (it has been flat for the past two years). Others point to the close match between wage and productivity growth in arguing that there will be no impact on prices. They also assert, however, that the increase will not spur consumption growth, but only keep it at current levels. At present the threat of inflation is minimal. The wage hikes combined with prospective income tax reductions and fading fears about the adverse impact of the strong yen are expected to encourage consumers not only to spend more but actually to save less.

On the other hand, restrained raises in the manufacturing sector, particularly for the automotive industry, will help Japan maintain its international competitiveness. The rapidity with which exporters have adjusted to the high yen has already shown up in the form of a return to positive growth in the volume of exports. The trend, which will surely be aided by moderate wage hikes, has raised fears in the government that Japan's trade surplus will actually expand in 1988, severely embarrassing Tokyo and exacerbating trade frictions.

The caveat to all this is that final shunto results will not be known until the end of May or early June. Given that there was a significant difference between initial and mid-term surveys (the average increase was initially reported to be 4.45 percent), the final results could show another discrepancy. The wage picture for all Japanese workers is likely to be more disappointing, since non-unionized workers, representing about 70 percent of total employment, generally receive increases 1 percent below the union average.

Jon Choy

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JEI

R E P O R T

A Two-Part Report: A and B

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THE DEBATE OVER JAPANESE INVESTMENT IN THE UNITED STATES

Summary

Foreign investment in the United States could soon rival trade as this country's major international economic policy concern. The increase in foreign acquisitions of U.S. companies and properties is spreading talk about "the buying of America." A number of people are even questioning whether the parallel growth of new direct investment is a plus for the economy. Doubts have also surfaced about the huge volume of foreign money invested in U.S. corporate and government securities or sitting in American bank accounts. In each case the worry is the same -- that the United States is ceding control of its economy to foreigners, particularly the Japanese.

The concern about Japanese investment is misplaced. Japan is not the biggest foreign investor in the United States and it is unlikely to catch up with direct and portfolio investment leader Britain in the foreseeable future. Moreover, while takeovers are on the upswing, Japanese investors, regardless of their business, still prefer to start from scratch. There is also no evidence that Japanese manufacturers investing in the United States are targeting strategic industries or companies. This country's dependence on Japanese capital to fund part of the federal budget deficit and finance corporate growth is a problem, but that is the result of the low U.S. savings rate.

New Concerns About Foreign Investment

Is foreign investment in the United States good for the economy? A few years ago the answer would have automatically been yes, but the sheer volume of

foreign investment and its rapid buildup are causing doubts. Foreign assets in this country soared from \$416 billion at the start of the 1980s to an estimated \$1.5 trillion at the end of 1987, with almost half of this jump coming in just the last two years. More than four-fifths of the total is invested in financial assets, including roughly \$500 billion in bank deposits, \$350 billion in corporate stocks and bonds and \$300 billion in Treasury securities. The other \$250 billion reflects the net book value of foreign direct investment in the United States -- defined as a foreign equity interest of 10 percent or more in a U.S. business or property.

Reagan administration policymakers have no doubts about the benefits of foreign purchases of government and corporate securities, crediting Japanese and other foreign investors with helping keep U.S. interest rates down and the current economic expansion going into its sixth year. Equally clear-cut to them are the advantages of foreign investment in manufacturing, distribution, financial services and other sectors of the economy. This activity, they argue, promotes growth by creating jobs, expanding the industrial base, generating income and tax revenues, and boosting exports. It also facilitates the introduction of new product and process technologies and management techniques and increases competition. Attaching some numbers to these claims, government economists note that the nonbank U.S. affiliates of foreign investors employed 3 million Americans at the end of 1986, including nearly 7 percent of all manufacturing workers, paid \$86.6 billion in wages and salaries, and accounted for nearly one-fourth of total U.S. exports.

Most Americans readily agree that foreign investment benefits the economy, but a cross-section of legislators, economists, business people, commentators and the public is starting to question whether all foreign investment is good for the United States. Are new plants in industries with excess capacity beneficial? Are foreign takeovers of major American companies healthy? Should foreign investment be limited in high technology industries and other strategic areas of the economy? How will the United States finance the interest payments on its huge and expanding international debt? Going one step farther, these skeptics ask whether the increasing volume of investment from abroad, portfolio as well as direct, gives foreigners too much influence on U.S. economic policy formation and the political process. To them the answer is already yes, even though foreign holdings in this country represent just 5 percent or so of all financial assets and an equally small proportion of tangible assets.

The growing American ambivalence toward foreign investment was captured in a recent poll by Smick-Medley & Associates Inc., a Washington consulting firm. A majority of the sample agreed that foreign direct investment creates additional jobs, introduces new and better business techniques and promotes competition, yet 40 percent backed legislation barring further investment while 89 percent thought foreign investors should be required to register. A late March Roper Organization poll for U.S. News & World Report identified similar worries that the benefits of foreign investment come at the expense of less economic control, with a plurality of the respondents objecting to the construction of foreign-owned plants in the United States even if that investment means more jobs. Moreover, 84 percent said that foreign purchases of American

companies and real estate hurt the economy, and by margins of at least 72 percent the people polled supported restrictions on foreign acquisitions of American high technology businesses, manufacturing companies, properties and firms making products vital to national security.

Whether on Capitol Hill, in the media or at the grass roots, the second thoughts about foreign investment increasingly center on the activities of one group of investors -- the Japanese. The USN&WR poll, for example, indicated that 58 percent of Americans were uncomfortable with the level of Japanese investment but only 37 percent were troubled by European investment. Surprising? In one sense, yes, since Japan, despite the conventional wisdom, is not the biggest investor in the United States and is unlikely to take over the number-one spot any time soon. That position is firmly held by Europe, which controlled an estimated \$780 billion worth of U.S. assets at the end of 1987 -- exactly half of foreign-owned financial and fixed assets here. The runner-up -- at \$268 billion or so -- is Latin America. Only then comes Japan at roughly \$195 billion.

Impressions aside once more, Japan is also a distant third in the direct investment rankings. Its \$30.9 billion stake in U.S. distribution operations, manufacturing facilities, real estate, and banking and finance ventures on December 31, 1987 paled next to the United Kingdom's \$70.5 billion tally and the Netherlands' total of \$51.5 billion (see Tables 1 and 2). True, Japanese investors have been expanding their holdings at a fast clip over the last few years but not that much faster percentage-wise than their British counterparts, who put \$19.1 billion into American businesses and properties in 1987 compared with a \$7.4 billion addition for Japan. Perception and reality are even farther apart when it comes to Japan's investment in the manufacturing sector since it trails not only the U.K. and the Netherlands but West Germany, Switzerland, France and Canada as well.

Despite the numbers, it is really not surprising that Japanese investment troubles the public more than Europe's expanding U.S. presence. Media attention alone almost guarantees that outcome. Over the last two years virtually every major American business magazine, news weekly and newspaper has run at least one cover story or feature article on what Japanese direct investors are doing in the United States, particularly in the manufacturing sector, but rarely does the coverage of European or Canadian investment go beyond individual transactions, ususally takeovers. Similarly, periodic reports that Japan's institutional investors might reduce their purchases of Treasury securities or pull some of their money out of the stock market leave the impression that the Japanese are the only foreign investors that count when it comes to interest rates or the stock market's performance; in fact, European institutional investors also play a critical role because of the size of their holdings.

The reaction to Japanese investment is also a by-product of the continuing debate over the causes of the huge U.S. trade deficit. Accustomed to singling out Japan's trade practices both here and at home as the major problem, many American naturally associate the perceived drawbacks of increased foreign investment with the activities of Japanese investors. For others, anxious about the erosion of this country's world economic and technical leadership, the expansion of Japanese-owned businesses in the United States is a constant reminder that Japan is the primary challenger.

Table 1: Foreign Direct Investment Position in the United States,
Yearend 1982-1987

(in millions of dollars)

	<u>1982</u>	<u>1983</u>	<u>1984</u>	<u>1985</u>	<u>Pre- liminary 1986</u>	<u>Esti- mated 1987</u>
United Kingdom	\$28,447	\$32,152	\$38,387	\$43,555	\$51,397	\$70,451
Netherlands	26,191	29,182	33,728	37,056	42,852	51,453
Japan	9,677	11,336	16,044	19,313	23,433	30,850
Canada	11,708	11,434	15,286	17,131	18,312	19,673
West Germany	9,850	10,845	12,330	14,816	17,356	17,416
Total	124,677	137,061	164,583	184,615	209,329	249,911
of which:						
Manufacturing	44,065	47,665	51,802	59,584	68,057	84,796
Wholesale Trade	18,397	21,031	24,455	29,051	31,927	34,269
Petroleum	17,660	18,209	25,400	24,231	24,962	n.a.
Real Estate	11,520	14,636	17,761	19,402	21,231	23,519
Insurance	7,928	8,665	8,922	11,806	13,623	16,353
Banking	7,846	8,697	10,326	11,377	12,388	12,729
Retail Trade	5,207	5,482	6,764	6,822	9,754	n.a.
Finance	2,159	2,269	5,633	4,246	4,903	7,325
Mining	1,876	1,928	3,920	4,039	4,665	n.a.
Other	8,019	8,478	9,599	14,058	17,820	19,218

Source: Department of Commerce

Table 2: Japan's Foreign Direct Investment Position in the United States,
Yearend 1982-1987

(in millions of dollars)

	<u>1982</u>	<u>1983</u>	<u>1984</u>	<u>1985</u>	<u>Pre- liminary 1986</u>	<u>Esti- mated 1987</u>
Total	\$9,677	\$11,336	\$16,044	\$19,313	\$23,433	\$30,850
Wholesale Trade	6,126	7,823	9,689	11,796	12,963	14,334
Manufacturing	1,624	1,605	2,460	2,738	3,017	4,633
Real Estate	396	515	744	1,536	2,480	4,182
Banking	1,325	1,384	1,853	2,160	2,745	3,222
Finance	-570	*	513	51	480	2,004
Retail Trade	151	234	252	251	292	n.a.
Insurance	169	182	138	119	*	n.a.
Mining	4	*	7	7	*	n.a.
Petroleum	113	-408	-88	31	-24	n.a.
Other	339	430	475	622	1,212	1,920

*Suppressed to avoid disclosure of data on individual companies.

Source: Department of Commerce

Then there is all the talk about the "buying of America." With the dollar's steep drop against the yen and major European currencies, U.S. assets now cost foreigners, as little as half of what they did three years ago. No matter that European and Canadian businesses have a long record of takeovers while their Japanese counterparts are newcomers to the mergers and acquisitions game, American opinion leaders and the public alike worry more about Japanese investors capitalizing on the yen's increased purchasing power than other foreigners using their extra financial leverage. Report after report of Japanese companies buying prime commercial real estate in New York City, Los Angeles and other major metropolitan areas -- often at record prices -- certainly factor into these fears, but what really troubles most people is that Japanese competitors will buy their way into a dominant position in the manufacturing and financial services sectors.

Misplaced Concerns About Japanese Investment

There is no question that Japanese acquisitions of domestic manufacturing facilities are on the rise. In just the first four months of 1988 Japanese companies finalized arrangements to purchase majority interests in 25 production operations -- not far off 1987's full-year tally of 33 or the comparable figure of 34 in 1986 (see Appendix). But one thing has stayed the same: Japanese corporations still prefer small acquisitions. In a world where billion-dollar deals no longer rate front-page coverage and \$100 million takeovers are considered routine business transactions, the vast majority of Japanese purchases fall into the \$50 million and under category, with most well below \$20 million. Only 21 of the 200 or so majority buyouts undertaken to date by Japanese investors cost more than \$50 million and just 13 had price tags of \$100 million-plus (see Table 3).

Even with a continued increase in the number of Japanese acquisitions, that split is unlikely to vary much. Moreover, huge transactions like Bridge-stone Corp.'s \$2.6 billion takeover of Firestone Tire & Rubber Co. or the \$2 billion purchase of CBS Inc.'s records operations by Sony Corp. will remain the exception. For one thing, not many Japanese companies are sitting on enough cash to go after big targets and few are willing to take on a sizable amount of debt to finance what is generally their first acquisition. Nor do most firms feel they have the experience in the United States to manage a large, established manufacturing venture.

There is also another part to the equation. Since Japanese businesses interested in acquisitions steer clear of hostile takeovers, their options are limited to what is for sale and that rarely includes Fortune 500-type manufacturers. The normal candidates are small companies in slow-growing businesses, secondary players in highly competitive industries and startups needing money to expand. In other cases manufacturers put on the market divisions or individual plants that no longer fit their long-term strategies.

At the same time, smaller deals often offer Japanese manufacturers exactly what they are looking for when they decide to go the takeover route. Topping this list are operations that complement existing product lines, although gaining a foothold in the American market runs a close second. Diversification, often into high technology fields, is the major objective for other companies, particularly businesses in smokestack industries. Some are interested in product or process know-how that will strengthen the competitiveness

Table 3: Major Japanese Acquisitions in the U.S. Manufacturing Sector*

(in millions of dollars)

<u>Investor</u>	<u>Manufacturer</u>	<u>Amount</u>	<u>Year</u>
Bridgestone Corp.	Firestone Tire & Rubber Co.	\$2,600.0	1988
Sony Corp.	CBS Inc.'s records operations	2,000.0	1988
Paloma Industries Ltd.	Rheem Manufacturing Co. (water heaters/air conditioners)	800.0**	1988
Dainippon Ink & Chemicals, Inc.	Sun Chemical Corp.'s graphic arts division (printing ink/pigments)	550.0	1986
Dainippon Ink & Chemicals, Inc.	Reichhold Chemicals Inc. (adhesives/polymers)	540.0	1987
Nippon Kokan K.K.	National Steel Corp. (50%)	292.0	1984
Sumitomo Rubber Industries, Ltd.	Dunlop Tire Corp.	245.0	1986
Fujitsu, Ltd.	Amdahl Corp. (19.5% to total of 46%) (computer equipment)	189.2	1984
Mitsubishi Mining & Cement Co., Ltd.	Kaiser Cement Corp.'s Cushenbury, CA cement operations	185.0	1988
Sunstar Inc.	John O. Butler Co. (toothbrushes)	163.5	1988***
Minebea Co., Ltd.	New Hampshire Ball Bearings Inc.	110.0	1985
Matsushita Electric Industrial Co., Ltd.	Motorola Inc.'s consumer electronics division	108.0**	1974
Showa Denko K.K.	BOC Group Inc.'s Airco Carbon division (graphite electrodes)	100.0	1988***
Suntory Ltd.	PepCom Industries Inc. (soft drinks)	100.0	1980
Juki Corp.	Union Special Corp. (industrial sewing machines)	92.8	1988***
Takata Corp.	Burlington Industries Inc.'s Industrial Fabrics division	79.0	1988
Daishowa Paper Manufacturing Co., Ltd.	James River Corp.'s Port Angeles, WA paper mill	75.0	1987
Hitachi Zosen Corp.	Clearing Inc. (stamping presses)	64.0	1986
Mitsubishi Heavy Industries, Ltd.	Beloit Corp. (20%) (pulp/paper making machinery)	60.0	1986
Onoda Cement Co., Ltd.	Lone Star Industries Inc.'s AK, OR and WA concrete/aggregates operations (50%)	60.0	1987
NTN Toyo Bearing Co., Ltd.	Federal Mogul Corp.'s bearings operations (60%)	54.0**	1985
Bridgestone Corp.	Firestone Tire & Rubber Co.'s LaVergne, TN truck tire plant	52.0	1982
Dainippon Ink & Chemicals, Inc.	Polychrome Corp. (84%) (industrial chemicals, film/plates)	52.0	1979

*Covers transactions through early May 1988. Unless otherwise indicated, the Japanese investor acquired all shares of the listed American manufacturing company.

**Estimated.

***Pending.

Note: For a complete listing of recent Japanese acquisitions in the U.S. manufacturing sector, see the Appendix.

of current products areas, but many would-be Japanese buyers of U.S. companies in high technology and other strategic industries have been scared off by the reaction to Fujitsu, Ltd.'s October 1986 attempt to acquire a controlling interest in Fairchild Semiconductor Corp. and subsequent signs of economic nationalism in this country.

One problem with all the talk of takeovers is that it obscures a basic fact about Japanese investment in the U.S. manufacturing sector: starting from the ground up is still the preferred alternative. New majority-owned production companies outnumbered acquisitions by a three-to-one margin last year and two to one in 1986. The split will probably be closer for 1988, but startups should be on top. This will provide added proof that critics are off base when they charge that Japanese investment does not really create that many jobs since much of the money goes into acquisitions. From the Japan Economic Institute's study of manufacturing and assembly companies in operation or under construction at the end of 1986 (see JEI Report No. 47A, December 18, 1987), it is already clear that Japanese investors are generating new employment opportunities for American workers. Even if every single job associated with acquired production companies is subtracted from the total job count, 70,000 positions are still left.

The critics have a fallback position, claiming that a significant number of the new jobs created by Japanese plant construction will eventually displace existing jobs in American-owned companies. This argument is primarily an outgrowth of the huge investment Japan's automotive manufacturers have made in U.S. production facilities. Told in the early 1980s that if they wanted to sell here they should produce here, Japanese competitors are now being accused by United Auto Workers union officials and automotive state legislators of exacerbating Detroit's capacity problems and contributing to the job losses in the industry. They maintain that in the soft American vehicle market of the late 1980s and early 1990s, the seven Japanese-affiliated car and truck operations in this country will take sales away from U.S. automotive makers on a one-for-one basis. This conclusion is not shared by industry analysts, many of whom argue that transplant sales will come largely at the expense of imports. But a recent U.S. General Accounting Office report found that even if 60 percent of the 1.8 million vehicles Japanese-affiliated plants are expected to produce in 1990 displace Big Three output, the transplant operations will create more final assembly and supplier jobs than are lost.

The automotive parts industry picks up the job-displacement argument at this point. It charges that the fast-expanding number of plants set up here by Japanese parts producers eliminates any chance that American suppliers can maintain employment at current levels. Japanese makers have built-in advantages in selling to Japanese-affiliated vehicle operations in this country because of the close ties between parts suppliers and motor vehicle manufacturers in Japan, domestic industry representatives say. They are also quick to charge that the competition has another, equally unfair edge in bidding for the growing amount of transplant business and the increasing volume of work outsourced by Detroit. That alleged advantage is the lower cost of investment resulting from state and local government economic incentives.

Whether the incentive packages provide a competitive advantage to Japanese parts suppliers and other manufacturers building U.S. plants is questionable. There is no debate, though, when it comes to the fairness issue. Despite

all the publicity about the competition among states for Japanese investment and the jobs this brings, Japanese companies moving into this country do not receive special treatment. Low-cost loans, grants, training funds, tax breaks and other incentives are available to any business, domestic or foreign, willing to build a facility in a new location or interested in expanding an existing operation.

Claims that Japanese companies investing in the United States have an unfair competitive advantage are nothing new; they have dogged Japanese banks for years. Japanese banks have rapidly expanded their American operations over the last 15 years or so, initially by catering to the banking needs of Japanese corporate clients in this country and more recently by developing a clientele among domestic businesses (see JEI Report No. 3A, January 22, 1988). But a number of acquisitions in the key California market (see Table 4) has also bolstered their position. And each triggers the same criticism from the U.S. banking industry: that Japanese banks operating in California are allowed to make purchases that are off-limits for out-of-state institutions and that federal regulators do not require them to meet the same standards of financial soundness as domestic banks.

This criticism should abate in the future since interstate banking is coming to California in 1991 and Japan has signaled its support for an international proposal to establish uniform capital adequacy ratios for the world's banks (see JEI Report No. 47B, December 18, 1987). Unfortunately, Japanese manufacturers investing in the United States will not get off the hook any time soon.

For further information, contact Susan MacKnight.

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The views expressed in this report are those of the author and do not necessarily represent those of the Japan Economic Institute.

JEI Report will not be published on June 3 because of the Memorial Day holiday. The next issue will be dated June 10, 1988.

Table 4: Major Japanese Acquisitions in the U.S. Financial Sector*

(in millions of dollars)

<u>Investor</u>	<u>Institution</u>	<u>Amount</u>	<u>Year</u>
<u>Commercial Banks</u>			
Bank of Tokyo, Ltd.	Union Bank	\$750	1988**
Group of 59 banks, securities firms and insurance companies	BankAmerica Corp.***	350	1987
Mitsubishi Bank, Ltd.	BanCal Tri-State Corp.	282	1984
Sanwa Bank, Ltd.	Lloyds Bank of California	263	1986
Mitsui Bank, Ltd.	Manufacturers Bank of Los Angeles	170	1981
Industrial Bank of Japan, Ltd.	J. Henry Schroder Bank & Trust Co. (75%)	110	1985
Bank of Tokyo, Ltd.	Southern California First National Bank	68	1975
Tokai Bank, Ltd.	Continental Bank	29	1981
Mitsubishi Bank, Ltd.	First National Bank of San Diego County	27	1981
Sanwa Bank, Ltd.	Golden State Bank	25	1978
<u>Brokerage Houses/Investment Banks</u>			
Nippon Life Insurance Co., Ltd.	Shearson Lehman Brothers Inc. (13%)	538	1987
Sumitomo Bank, Ltd.	Goldman Sachs & Co. (12.5%)	500	1986
Yasuda Mutual Life Insurance Co., Ltd.	PaineWebber Group Inc. (18%)	300	1987
Nomura Securities Co., Ltd.	Eastdil Realty Inc. (25%)	25	1987
<u>Primary Dealers</u>			
Industrial Bank of Japan, Ltd.	Aubrey G. Lanston & Co.****	234	1986
Sanwa Bank, Ltd.	Brophy, Gestal, Knight & Co. (80%)	80	1988**
Fuji Bank, Ltd.	Kleinwort Benson Government Securities Inc. (24.9%)	15	1988**
<u>Finance Companies</u>			
Fuji Bank, Ltd.	Walter E. Heller International Corp.	425	1984
Sanwa Bank, Ltd.	Continental Illinois Leasing Corp.	50	1985
Mitsui & Co., Ltd.	American Acceptance Corp.	34	1987
Lake Co., Ltd.	Imperial Thrift and Loan Association	14	1984

*Covers transactions through early May 1988. Unless otherwise indicated, the Japanese investor acquired all shares of the listed American financial institution.

**Pending.

***Capital infusion.

****The purchase was made through J. Henry Schroder Bank & Trust Co., in which IBJ has a 75 percent interest.

APPENDIX: Japanese Acquisitions of U.S. Manufacturing Companies*

(in millions of dollars)

1988 Transactions

<u>Investor</u>	<u>Manufacturer</u>	<u>Amount</u>
Bridgestone Corp.	Firestone Tire & Rubber Co.	\$2,600.0
Sony Corp.	CBS Inc.'s records operations	2,000.0
Paloma Industries Ltd.	Rheem Manufacturing Co. (water heaters/air conditioners)	800.0**
Mitsubishi Mining & Cement Co., Ltd.	Kaiser Cement Corp.'s Cushenbury, CA cement operations	185.0
Sunstar Inc.	John O. Butler Co.*** (toothbrushes)	163.5
Showa Denko K.K.	BOC Group Inc.'s Airco Carbon division*** (graphite electrodes)	100.0
Juki Corp.	Union Special Corp.*** (industrial sewing machines)	92.8
Takata Corp.	Burlington Industries Inc.'s Industrial Fabrics division	79.0
Kirin Brewery Co., Ltd.	Coca-Cola Bottling Co. of Northern New England (75% did not own)	46.5
CKD Corp.	Templeton Kenly & Co.*** (cylinders/jacks)	40.0
Sakata Corp.	Acme Printing Ink Co. (75% did not own)	40.0
Sanden Corp.	Vendo Co. (vending machines)	24.3
Furukawa Electric Co., Ltd.	Bell Industries, Inc.'s magnetic disk division	20.0
Nakano Vinegar Co., Ltd.	Indian Summer Inc.'s Evansville, IN and Belding, MI vinegar plants	10.5
Graphtec Corp.	Precision Image Co. (36% for total of 40.7%) (plotters)	7.0
Sunwave Industrial Corp.	Caddy Corp. of America*** (kitchen equipment)	5.0
Taiyo Yuden Co., Ltd.	Xentek, Inc. (80%) (power supplies)	5.0
Riken Corp.	Duriron Co., Inc.'s Modern Industrial Plastics division	4.5
Hermanos Miwa Inc.	J.G. Tilp, Inc. (plastic molds)	2.0
A&D Co., Ltd.	Zonic Corp. (30%) (analyzers)	2.0
Tokyo Tokushu Nekko Co., Ltd.	International Pressure Service Inc. (isotatic presses)	0.8**
Kao Corp.	Andrew Jergens Co.*** (personal care products)	n.a.
Kawai Musical Instruments Co., Ltd.	Lowrey Industries Inc. (organs/pianos)	n.a.
Rohto Pharmaceutical Co., Ltd.	Mentholatum Co.*** (pharmaceuticals)	n.a.
Suntory Ltd.	Polar Water Co. (bottled water)	n.a.
Taiyo Oil Co., Ltd.	John T. Handy Co. (seafood processing)	n.a.
Yamaha Corp.	Sequential Circuits Inc. (electronic musical instruments)	n.a.

1987 Transactions

<u>Investor</u>	<u>Manufacturer</u>	<u>Amount</u>
Dainippon Ink & Chemicals, Inc.	Reichhold Chemicals Inc. (adhesives/polymers)	\$540.0
Daishowa Paper Manufacturing Co., Ltd.	James River Corp.'s Port Angeles, WA paper mill	75.0
Onoda Cement Co., Ltd.	Lone Star Industries Inc.'s AK, OR/WA concrete/aggregates operations (50%)	60.0
Yoshida Kogyo K.K.	Universal Fasteners, Inc. (buttons/snaps)	48.0
Ryobi Ltd.	Inertia Dynamics Corp. (60% for total of 94%) (weed trimmers/leaf blowers)	47.2**
NEC Corp.	Honeywell Inc.'s information systems division (15%)	47.0
Tateho Chemical Industries Co., Ltd.	Advanced Composite Materials Corp. (silicon-carbide whiskers)	25.0
Kubota, Ltd.	Mips Computer Systems Inc. (20%) (computers)	22.6
Marubeni Corp.	Helena Chemical Co. (agricultural chemicals)	21.0**
Nitto Electric Industrial Co., Ltd.	Hydranautics Inc. (membranes/water purification systems)	19.2**
Nippon Piston Ring Co., Ltd.	Goetze Corp. of America (25%) (piston rings/gaskets)	18.0
House Food Industrial Co., Ltd.	Foremost Dairies-Hawaii	15.5
Kubota, Ltd.	Akashic Memories Corp. (hard disks)	15.4**
Kao Corp.	High Point Chemical Corp. (textile/industrial chemicals)	13.3**
NHK Spring Co., Ltd.	Neoax Inc.'s Mather Metals division (automotive stabilizers)	11.5
Nippon Steel Corp.	GTX Corp. (25%) (computer equipment)	10.0
Aderans Co., Ltd.	International Hairgoods Inc. (hairpieces)	9.3
FSK Inc.	Madico, Inc. (solar control/metallized film)	8.3
Ito-En Co., Ltd.	Shimoko and Sons (soft drinks)	7.0
Okabe Co., Ltd.	Elco Industries Inc. (11%) (fasteners)	6.9**
Leonix Corp.	Cooper LaserSonics, Inc.'s ion laser division	6.0
Marubeni Corp./Fuji Electric Co., Ltd.	RPC Industries (34.4%) (industrial curing systems)	5.0
Sapporo Breweries Ltd.	St. Clement Vineyards (wine)	5.0
Sumitomo Bakelite Co., Ltd.	Sheldahl Inc. (10%) (printed circuit boards)	4.9
Nippon Mining Co., Ltd.	Irvine Scientific Sales Co., Inc. (80%) (culture mediums)	3.6
Marubeni Corp.	Autron Inc. (paper)	3.5
Chugai Booki Co., Ltd.	Vicon Industries Inc. (10.8%) (closed-circuit TV systems)	3.0
Mitsubishi Metal Corp.	Cox Creek Refining Co. (20%) (electrolytic copper/copper wire)	3.0

1987 Transactions (continued)

Investor	Manufacturer	Amount
Nakano Vinegar Inc.	Indian Summer Inc.'s Sodus, NY vinegar plant	\$2.1
Sapporo Breweries Ltd.	Abbott Vineyards (wine)	1.0
Sanraku Inc.	Markham Vineyards (wine)	0.7**
Yamamoto Kogaku Co., Ltd.	Elastomer Technology Inc. (urethane products)	0.3
Asahi Diamond Industrial Co., Ltd.	Permattach Diamond Tool Corp. (50%) (industrial diamond tools)	n.a.
Asahi Glass Co., Ltd. (50%)/ Olin Corp. (50%)	Aegis Inc. (IC packages)	n.a.
Kirin Brewery Co., Ltd.	Coca-Cola Bottling Co. of Northern New England (25%)	n.a.
Kobe Steel, Ltd.	Breed Automotive Corp. (20%) (automotive air bags)	n.a.
Kokusen Kinzoku Kogyo Co., Ltd.	Master Cast Co. (70%) (die castings)	n.a.
Misuzu Coffee Co., Ltd., Mitsubishi Corp./Sumida Corp.	Hill & Hill Kona Coffee Specialists Inc.	n.a.
Mitsubishi Chemical Industries, Ltd.	Western Litho Plate & Supply Co. (printing plates)	n.a.
Mitsui & Co., Ltd.	Kaiser Steel Tubing Inc.	n.a.
Otsuka Pharmaceutical Co., Ltd.	Ridge Vineyards (wine)	n.a.
Sakata Corp.	Acme Printing Ink Co. (25%)	n.a.
Sekisui House, Ltd.	West Coast Forest Products Inc. (lumber)	n.a.
Swany Corp.	Elmer Little & Sons Inc. (gloves)	n.a.
Toyoda Machine Works Ltd.	Grinders for Industry Inc. (machine tools)	n.a.

1986 Transactions

Investor	Manufacturer	Amount
Dainippon Ink & Chemicals, Inc.	Sun Chemical Corp.'s graphic arts division (printing ink/pigments)	\$550.0
Sumitomo Rubber Industries, Ltd.	Dunlop Tire Corp.	245.0
Hitachi Zosen Corp.	Clearing Inc. (stamping presses)	64.0
Mitsubishi Heavy Industries, Ltd.	Beloit Corp. (20%) (pulp/paper making machinery)	60.0
NGK Insulators, Ltd.	Cabot Corp.'s Wrought Products division	45.0
Fujikura Ltd. (49%)/Aluminum Co. of America (51%)	PEP Industries Inc. (automotive wire harnesses)	35.0
Mitsubishi Mining & Cement Co., Ltd./ Mitsubishi Corp.	Siltec Corp. (silicon wafers)	33.0
Settsu Corp.	MedaSonics, Inc. (ultrasound diagnostic equipment)	15.0
Ryobi Ltd.	Inertial Dynamics Corp. (34%) (weed trimmers/leaf blowers)	12.4**
Toshiba Ceramics Co., Ltd.	Quartz International Corp. (quartz/pyrex apparatus)	11.4
Sanyo Electric Co., Ltd.	Design & Manufacturing Corp.'s Richmond, IN refrigerator plant	11.0
Dainichiseika Colour & Chemicals Manufacturing Co., Ltd.	Pope Chemical Co. (pigments)	10.0
Kanzaki Paper Manufacturing Co., Ltd.	Ludlow Corp.'s Ware, MA paper mill	10.0
Tsubakimoto Chain Co.	Union Chain Co.	10.0
Rohm Co., Ltd.	Exel Microelectronics, Inc. (integrated circuits)	5.7
Mitsui & Co., Ltd.	Bioproducts, Inc. (pet food flavorings/fish food)	5.2
Nippon Sanso K.K. (50%)/AmeriGas Corp. (50%)	Isotec Inc. (stable isotopes)	5.0**
Toyoshima Special Steel Co., Ltd.	Service Spring Co. (leaf springs)	5.0
Fuji Filter Manufacturing Co., Ltd.	Michigan Dynamics, Inc. (35%) (filters)	4.0
Dainippon Ink & Chemicals, Inc.	Rachwal Systems, Inc. (camera systems)	3.9
Yazaki Corp.	Circuit Controls Corp. (terminals for wire harnesses)	3.75
Otsuka Pharmaceutical Co., Ltd.	Phospho-Energetics Inc. (40%) (NMR imaging systems)	3.0
Hosokawa Micron Corp.	W.W. Criswell Corp. (industrial filter bags)	2.5
Fuji Steel Co., Ltd.	Oliver America High Point Woodworking Co., Inc. (furniture)	2.1
Sokkisha Co., Ltd.	Pyramid Optical Corp. (optical prisms)	2.1
Nakano Vinegar Co., Ltd.	Lyndonville Vinegar Inc.	2.0
Kawasho Corp.	Western Metal Building Products Co., Inc.	1.3
Kotobuki Seating Co., Ltd.	Interkal, Inc. (40%) (indoor seating)	1.3**
Nitto Boseki Co., Ltd.	International Immunology Corp. (65%) (diagnostic reagents)	1.3
Mitsubishi Rayon Co., Ltd.	Poly-Optical Products Inc. (10%) (fiber-optic components)	0.4
Takara Shuzo Co., Ltd.	Honolulu Sake Brewery and Ice Co. (sake/soy sauce)	0.3
Fanuc Ltd.	General Electric Co.'s automation controls division (45%)	n.a.
Hitachi Cable, Ltd.	Phalo Corp.'s cable division	n.a.
Kawasaki Steel Corp.	California Steel Industries Inc. (25% for total of 50%) (steel sheets/coils)	n.a.
Kobe Steel, Ltd.	GCA Corp.'s laser inspection equipment division	n.a.
Osaka Titanium Co., Ltd.	U.S. Semiconductor Corp. (silicon wafers)	n.a.
Shibuya Kogyo Co., Ltd.	Kris-Tech Corp. (packaging machines)	n.a.
Shizuki Electric Co., Ltd.	TRW Inc.'s capacitor division	n.a.
Sumitomo Heavy Industries, Ltd.	FMC Corp.'s construction equipment business (49%)	n.a.
Sumitomo Heavy Industries, Ltd.	Radiation Dynamics, Inc. (electron beam accelerators)	n.a.

1986 Transactions (continued)

<u>Investor</u>	<u>Manufacturer</u>	<u>Amount</u>
Takatori Corp.	Intech Corp. (hosiery finishing machinery)	n.a.
Tateho Chemical Industries Co., Ltd.	Combustion Engineering Inc.'s Greenville, TN fused magnesium plant	n.a.
Toshiba Corp.	Minnesota Mining and Manufacturing Co.'s Mitchell, SD copier toner plant	n.a.
Yazaki Corp.	VDO Adolf Schindling AG's Winchester, VA automotive instrument panel plant (50%)	n.a.

1985 Transactions

Minebea Co., Ltd.	New Hampshire Ball Bearings Inc.	\$110.0
NTN Toyo Bearing Co., Ltd.	Federal Mogul Corp.'s bearings operations (60%)	54.0**
Fujisawa Pharmaceutical Co., Ltd.	LyphoMed Inc. (22.5%) (injectable drugs)	26.3
Hosokawa Micron Corp.	U.S. Filter Systems Inc. (filter media, bags/cloths)	25.0**
Nisshin Steel Co., Ltd.	Thinsheet Metals Co.	20.0
Nippon Kokan K.K.	General Electric Co.'s Great Western Silicon division	18.0
Minebea Co., Ltd.	Harris Corp.'s Miami Lakes, FL power supply unit	12.4**
Mitsubishi Corp.	Kux Manufacturing Co. (lettering, decals/building signs)	12.3**
Koike Sanso Kogyo Co., Ltd./Nippon Sanso K.K.	BOC Group Inc.'s gas cutting tool division	10.0
Namco K.K.	Atari Games Inc. (majority interest) (video game machines)	10.0
Alps Electric Co., Ltd.	Apple Computer Inc.'s Garden Grove, CA keyboard plant	9.9**
Kawasaki Steel Corp.	NBK Inc. (silicon wafers)	9.4
Kawasho Corp.	Alerco Manufacturing Co. (metal building products)	8.6
Toray Industries, Inc.	Trea Industries Inc. (polypropylene film)	8.0
Mitsubishi Electric Corp.	General Electric Co.'s and Westinghouse Electric Corp.'s discrete devices operations (10%)	5.0
Nissho Iwai Corp.	Berwick Steel Co. (steel processing)	4.5
Kawasaki Steel Corp.	General Electric Co.'s steam injection pipe division (75%)	4.0
Barudan Co., Ltd.	Meistergram, Inc. (monogramming/embroidery machinery)	4.0
Marubeni Corp.	Bleim Steel Co. (steel processing)	3.2
Fujisawa Pharmaceutical Co., Ltd.	PMP Fermentation Products Inc. (enzymes/chelating agents)	1.0
Nippon Mining Co., Ltd.	Koltron Corp. (36.7%) (lead frames for integrated circuits)	0.1**
Aderans Co., Ltd.	Charles Alfieri Inc. (hairpieces)	n.a.
Mitsubishi Corp.	SiScan Systems Inc. (25%) (semiconductor test equipment)	n.a.
Nippon Steel Corp.	Electro-Plasma, Inc. (75%) (plasma spray equipment)	n.a.
Nitto Seiko Co., Ltd.	VSI Automation Assembly, Inc. (riveting machines)	n.a.
Sumitomo Corp.	Industrial Metals Corp. (steel processing)	n.a.
Suntory Ltd.	Kentwood Spring Water Inc. (bottled water)	n.a.
Tsuzuki Spinning Co., Ltd.	Avondale Mills Inc.'s Eufaula, AL cotton yarn plant	n.a.

Selected Transactions Before 1985

<u>Investor</u>	<u>Manufacturer</u>	<u>Year</u>	<u>Amount</u>
Nippon Kokan K.K.	National Steel Corp. (50%)	1984	\$292.0
Fujitsu, Ltd.	Amdahl Corp. (19.5% for total of 46%) (computer equipment)	1984	189.2
Matsushita Electric Industrial Co., Ltd.	Motorola Inc.'s consumer electronics division	1974	108.0**
Suntory Ltd.	PepCom Industries Inc. (soft drinks)	1980	100.0
Bridgestone Corp.	Firestone Tire & Rubber Co.'s LaVergne, TN truck tire plant	1982	52.0
Dainippon Ink & Chemicals, Inc.	Polychrome Corp. (84%) (industrial chemicals, film/plates)	1979	52.0
Nippon Kokan K.K.	Martin Marietta Corp.'s Torrance, CA aluminum casting plant (40%)	1984	45.0
Suntory Ltd.	Chateau St. Jean (wine)	1984	40.0
Toyo Menka Kaisha, Ltd.	Chickasha Cotton Oil Co.	1981	28.8
Kawasaki Steel Corp.	California Steel Industries Inc. (25%) (steel sheets/coils)	1984	27.5
Nichiro Gyogyo Kaisha Ltd.	Peter Pan Seafoods Inc.	1979	23.5
Sumitomo Metal Industries, Ltd.	Tube Turns Inc. (steel forgings/engineered products)	1983	21.7**
Kirin Brewery Co., Ltd.	Coca-Cola Bottling Co. of Salem, New Hampshire	1982	16.5
Mitsui & Co., Ltd.	Diamond Shamrock Corp.'s feed additive division	1981	15.0
Murata Manufacturing Co., Ltd.	Erie Technological Products, Inc. (capacitors)	1980	14.0
Sanyo Electric Co., Ltd.	Warwick Electronics Inc. (75%) (televisions)	1977	13.8
Nippon Seiko K.K.	Hoover NSK Bearing Co. (50% did not own)	1975	10.6
Shin-Etsu Handotai Co., Ltd.	Hemlock Semiconductor Corp. (24.5%) (silicon)	1984	10.5**

Selected Transactions Before 1985 (continued)

<u>Investor</u>	<u>Manufacturer</u>	<u>Year</u>	<u>Amount</u>
Minebea Co., Ltd.	Hi-Tek Corp. (computer keyboards)	1983	\$10.0
Tokyo Rope Manufacturing Co., Ltd., C. Itoh & Co., Ltd./Mitsubishi Corp.	Firestone Wire & Cable Co. (tire cord/bead wire)	1981	10.0
Dainippon Ink & Chemicals, Inc.	Kohl & Madden Printing Ink Corp.	1976	9.2**
Wacoal Corp.	Teenform Inc. (lingerie)	1983	8.5
Mitsubishi Corp.	Gifford-Hill & Co.'s PVC pipe operations	1982	7.0
Minebea Co., Ltd.	Pacific Propeller Inc. (aircraft propellers)	1982	6.0
Mitsui & Co., Ltd.	Superene Feed Supplement Corp.	1984	6.0
Toyota Motor Corp.	Atlas Fabricators Inc.'s truck cargo bed plant	1974	6.0
Nakano Vinegar Co., Ltd.	American Industries Co. (vinegar)	1981	5.5
Toyo Menka Kaisha, Ltd.	Diamond Perforated Metals Co. (80X)	1974	5.3
Minebea Co., Ltd.	Universal Magnetica, Inc. (motors)	1984	5.0
Minebea Co., Ltd.	P.R. Mallory & Co.'s Hansen Manufacturing division (electric motors)	1977	4.6
Daiichiya Baking Co., Ltd.	ITT Continental Baking Co.'s Hawaii plant	1981	4.3**
Takasago Corp.	International Flavors & Fragrance Inc.'s Teterboro, NJ food flavoring plant	1983	3.0
Toshiba Corp.	Maruman Integrated Circuits Inc.	1980	2.7
Koa Denko Co., Ltd.	Airco, Inc.'s Speer Electronics division (51X) (resistors)	1980	2.6**
Mitsubishi Chemical Industries, Ltd.	USR Chemicals Inc. (fluorescent material)	1981	2.3
Mitsuboshi Belting Ltd.	Chemi-Flex Inc. (polyurethane belts)	1979	2.0
Sekisui Chemical Co., Ltd.	Precision Polymers Inc.'s PVC pipe division	1978	2.0
Nippon Chemi-Con Corp.	Data Ray Corp. (video display monitors)	1983	1.8
Mitsubishi Chemical Industries, Ltd.	GAF Corp.'s X-ray intensifying screen division	1981	0.4
Nakano Vinegar Co., Ltd.	Merit Group's vinegar division	1983	0.4

*Covers transactions through early May 1988. Unless otherwise indicated, the Japanese investor acquired all shares of the listed American manufacturing company. Year refers to year the transaction was completed.

**Estimated.

***Pending.

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JEI

R E P O R T

A Two-Part Report: A and B

NO. 21B
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Forecasters Upbeat About Economy

The 3.7 percent real economic growth projected last December by Japan's private-sector economists seemed a remarkably rosy picture of the economy for the fiscal year starting in April 1988. After all, the yen was rising again before the economy had fully adjusted to the run-up that started in February 1985, and October's stock market crash was a fresh memory.

With the new fiscal year barely under way, many of the same forecasters now say they were too pessimistic in December. They are now expecting 4.3 percent real growth on average in FY 1988 (see Table). The biggest difference is the estimated strength of domestic demand. For example, NRI and NCC Co., Ltd. (Nomura Research) is now expecting domestic growth of 5.3 percent rather than

the 4.9 percent it projected in December. (For details of earlier forecasts, see JEI Report No. 8A, February 26, 1988.)

Summary of Revised Forecasts, FY 1988

	<u>Real GNP Growth</u>		<u>Current</u>	<u>Y/\$</u>	<u>Oil Prices</u>
	<u>Initial</u>	<u>Revised</u>	<u>Account</u>	<u>Exchange</u>	<u>(\$/barrel)</u>
			<u>Surplus*</u>	<u>Rate</u>	
Fuji Bank	3.7%	4.1%	\$73.0	Y122.0	\$16.1
Industrial Bank of Japan	3.6	4.3	78.8	120.0	17.6
Japan Economic					
Research Center	3.7	4.2	75.0	120.6	18.1
Daiwa Securities					
Research Institute	4.0	4.7	72.7	122.8	16.5
Okasan Economic					
Research Institute	3.7	4.5	n.a.	124.0	18.0
NRI and NCC (Nomura					
Research Institute)	3.6	4.1	78.7	123.0	16.0
Average Forecast	3.7	4.3	75.6	122.1	17.2

*In billions of dollars.

Other parts of the forecasts have shown less change. The yen is still expected to be stable over the fiscal year. The predicted value of Y122.1=\$1.00 rather than the 127.7 yen to the dollar estimated earlier mainly reflects the appreciation that occurred between the two forecasts.

With their new projections, private-sector economists are now more optimistic than the government, which is still expecting 3.8 percent real growth. The new estimates, however, are in line with the Organization for Economic Cooperation and Development's. OECD now predicts 4.25 percent real growth for Japan in calendar 1988, an increase over its December estimate of 3.5 percent. (In 1987 the economy grew 4.2 percent.) The new 1988 projection puts Japan substantially ahead of the 3 percent average for all OECD countries and the 2.75 percent forecast for the United States, both of which are also higher than earlier estimates.

The OECD projection differs somewhat from the projections of Japan's private-sector economists on the direction of the current account surplus. The latter forecasters estimate an average \$75.6 billion surplus in FY 1988, down substantially from FY 1987's \$84.5 billion figure but close to their earlier projection of \$75.4 billion. In contrast, the OECD expects a surplus of \$85 billion in 1988, virtually unchanged from last year's \$87 billion. While any of these amounts would leave the current account surplus at a historically high level, private-sector Japanese economists are more optimistic that it will continue falling.

The OECD forecast is similar to the results of a new informal survey of trading companies and manufacturers by the Ministry of International Trade and Industry, which suggests that the customs-clearance trade surplus will be \$76 billion in FY 1988, the same level reached in FY 1987 but higher than the official government outlook of \$68 billion. MITI bases its conclusion in part on

resumed export growth. Overseas shipments were off 0.5 percent in volume terms in FY 1987 but are expected to grow about 2 percent in FY 1988 despite an average exchange rate of ¥125=\$1.00 instead of the ¥138=\$1.00 recorded in the April 1987-March 1988 period.

If these MITI and OECD forecasts are correct, the foreign sector will be neither an engine of growth, as it sometimes has been in the past, nor a drag on expansion, as it was in 1986 and 1987. American policymakers are likely to be pleased with the continued strong growth of the Japanese economy but unhappy that the trade surplus may remain around its present high level for the foreseeable future.

Douglas Ostrom

Japanese Continue To Buy U.S. Bonds

Despite wariness over rising U.S. interest rates and worries that recent exchange rate stability would not last, Japanese institutional investors went on a buying spree during the U.S. Treasury Department's latest quarterly refinancing operation. The hesitancy of Japanese investors and the willingness of Treasury officials to time the auction to attract them reveals the strong links that have bound the two countries tightly together. The important, almost key, role the Japanese play has raised concerns in the United States that control of monetary policy is becoming unduly influenced by foreign considerations.

The Treasury Department postponed the \$26 billion quarterly auction to avoid a three-day Japanese holiday at the start of May. The action was partly in response to reports that Japanese fund managers were unenthusiastic about the bond sale. Reports of unexpectedly strong U.S. economic activity had raised fears of an overheating economy and higher interest rates. Managers were worried that the yield on 30-year bonds would jump as high as 9.25 percent compared with the coupon value of 8.875 percent. Worries over the yen-dollar exchange rate also plagued Japanese managers, and some analysts argued that the dollar's gradual weakening over the past year was due to this concern. Unfortunately, this situation could create a vicious cycle since less Japanese investment in U.S. bonds would reduce demand for dollars, pushing the American currency down and making dollar-denominated instruments even less attractive.

In the end, however, there was no visible reduction in Japan's participation. An estimated 20 percent of the \$8.75 billion worth of three-year Treasury notes went to Japanese bidders, carrying an average yield of 8.23 percent. Treasury officials report that the bid-to-cover ratio (the value of bids made divided by the amount accepted) was 2.95, which compares favorably with the last auction's 2.43 ratio. As for the \$8.75 billion worth of 10-year notes, Japanese investors bid successfully for 35 to 40 percent. The average yield on the notes was 9.06 percent, a slim margin given the 9 percent coupon. In this case the bid-to-cover ratio was also higher than earlier, coming in at 2.61 versus 2.04.

Traders were pleasantly surprised at the active bidding despite the fact that several major U.S. commercial banks raised their prime lending rate a quarter of a point just before the auction and that Council of Economic Advisors chairman Beryl Sprinkel confirmed that U.S. monetary policy had been tightened. This set the stage for the final day's auction of \$8.5 billion

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J E I

R E P O R T

A Two-Part Report: A and B

NO. 22A

June 10, 1988

JAPANESE DEBT MARKETS: AN OVERVIEW

Summary

Although patterned after American models, Japanese debt markets developed different characteristics in response to the nation's individual needs. Many of these features impeded foreign access, but they have been eliminated or eroded as Tokyo's financial liberalization program has progressed. With Japan's huge surplus of savings, domestic markets will surely attract an increasing number of capital-hungry foreigners. By opening and modernizing its debt markets, Japan can play a much bigger role in keeping the global economy growing.

The Basics

At first glance, Japanese debt markets appear to be carbon copies of American markets. The central and local governments issue bonds of various maturities for general revenue and public works projects; credit associations and long-term credit banks offer debentures to fund their operations; and corporations can offer both secured and unsecured straight, convertible and warrant bonds. The over-the-counter market for government bonds is well-developed; so is the market for bonds with repurchase agreements (the gensaki market). A wide range of foreign-issued and foreign currency-denominated notes is also available. With the recent addition of a commercial paper market, it seems that there is an instrument tailored for every need.

Closer examination reveals, however, that Japan's debt markets differ in important respects from this country's.

Public bonds - The central government issues both long-term bonds and short-term notes for general revenue purposes as well as bonds to fund public

works projects or other special programs. The sale of the majority of long-term general revenue bonds (with maturities of five, 10 or 20 years) is arranged through negotiations between the Bank of Japan and an underwriting syndicate composed of all types of financial firms. About one-fourth to one-third of any one issue is placed with official accounts, such as the national pension fund or various semi-governmental agencies (see Table 1).

This system is a legacy of the extreme economic and financial conditions immediately after World War II. Given the very low yield of government bonds compared with the return on money lent or raised for investment in plant and equipment, financial institutions had to be induced to participate in the underwriting consortium. Since the needs of reconstruction insured that the demand for funds to invest far outstripped the supply, banks and securities companies went along with the syndicate system to assure access to the BOJ's discount window, a source of emergency funds. For many years, therefore, this system was a powerful monetary policy tool. When the economy began to overheat, the amount and/or terms of the monthly issue were changed to drain liquidity from the market (syndicate members are obligated to buy the bonds) and put a brake on investment activity.

The amount of a long-term bond issue and its terms are set during the negotiations between the BOJ and the syndicate leadership, although the unequal positions of the two sides usually meant until recently that the BOJ dictated the terms. Distribution of the bonds among the 815 syndicate members is governed by fixed shares set by the Ministry of Finance and the syndicate leadership.

Until the 1980s only three foreign firms were allowed to participate in the underwriting syndicate. This was not a problem as long as long-term bonds remained unattractive. (The low yields did not attract buyers outside the syndicate, meaning members were stuck holding them.) Since the government began to roll over the large amount of deficit-financing bonds issued during the 1970s, however, yields have improved. Lower capital spending, continued high savings rates and a gradual freeing of interest rates have forced the government to offer more attractive terms to keep the syndicate system viable.

The higher yields have attracted foreign interest. Fifteen foreign companies had joined the syndicate by 1984 and another 49 since then for a total of 64. The share allotted to foreign firms, however, has remained tiny (under 7 percent), even though they are interested in increasing their participation (see JEI Report No. 22B, June 6, 1987). With Japanese firms increasingly active in foreign bond markets, particularly in this country, foreign companies have been clamoring for a bigger share of the Japanese pie. This issue will be examined in greater detail below.

Short-term central government notes (with maturities of two to four years) are distributed in one of two ways. An auction system very similar to that used in the United States has been in place since 1978. A fixed-rate system for special-purpose flotations was introduced in 1982. Since the auction system produces a more competitive instrument, the secondary market for short-

Table 1: Government Bond Issues Planned for Fiscal 1988

(in trillions of yen)

	New Revenue			Refunding		
	Total	Construction Bonds	Deficit Bonds	Total	Construction Bonds	Deficit Bonds
Syndicate underwriting	Y4,051.0	Y2,190.0	Y1,861.0	Y4,749.0	Y2,243.5	Y2,505.5
Discount notes	500.0	500.0	0.0	0.0	0.0	0.0
10-year bonds	3,551.0	1,690.0	1,861.0	4,749.0	2,243.5	2,505.5
Public auction	1,500.0	1,500.0	0.0	5,493.3	5,493.3	0.0
Treasury bills	0.0	0.0	0.0	2,257.6	2,257.6	0.0
Medium-term notes	1,100.0	1,100.0	0.0	1,635.7	1,635.7	0.0
20-year bonds	400.0	400.0	0.0	1,600.0	1,600.0	0.0
Trust Fund Bureau	1,500.0	750.0	750.0	2,000.0	2,000.0	0.0
10-year bonds	750.0	0.0	750.0	1,000.0	1,000.0	0.0
20-year bonds	750.0	750.0	0.0	1,000.0	1,000.0	0.0
Postal savings underwriting	950.0	600.0	350.0	300.0	300.0	0.0
10-year bonds	950.0	600.0	350.0	300.0	300.0	0.0
Direct sales through post offices	840.0	650.0	190.0	160.0	160.0	0.0
Discount notes	40.0	40.0	0.0	0.0	0.0	0.0
Medium-term notes	110.0	110.0	0.0	160.0	160.0	0.0
10-year bonds	690.0	500.0	190.0	0.0	0.0	0.0
Replacement (official accounts)	0.0	0.0	0.0	1,807.9	1,504.8	303.1
Trust Fund Bureau	0.0	0.0	0.0	1,807.9	1,504.8	303.1
Bank of Japan						
Total	8,841.0	5,690.0	3,151.0	14,510.2	11,701.6	2,808.6
						23,351.2

Source: Bond Underwriters Association of Japan, Bond Review.

term government notes has developed in a steady fashion. Compared to the U.S. market, however, the one in Japan is small and restricted.

Government-guaranteed bonds are issued by the central government for specific purposes, usually to finance public works projects. The total amount to be issued in the fiscal year is determined by the general account budget. Placement of each monthly issue is entrusted by the Bank of Japan to a commercial underwriter, usually one of the long-term credit banks. In turn, the institution organizes an underwriting syndicate to handle distribution to institutional and individual investors. The terms of each issue are subject to some negotiation but are usually attractive enough to encounter no market resistance.

Local governments also float bonds every year under a system supervised by the Ministry of Finance through the Home Affairs Ministry. Each local government appoints a trustee, usually a local bank, to lead the issues for the year. The trustee often organizes and then negotiates with a syndicate made of up local and national institutions. If the terms are acceptable to the central government, the flotation proceeds.

Corporate bonds - While the end result is the same, the Japanese method of issuing corporate bonds is different from the American practice, mainly because of more restrictive regulations. The issuing company appoints a managing underwriter, usually its main securities broker, and a trustee, normally its major bank. The managers and trustees meet once a month to review which corporations are scheduled to issue bonds the following month and to negotiate the terms. If they feel the market cannot absorb all the planned issues, the total amount of bond issues is also negotiated. Because regulations specify the time between announcement of a bond and its placement and then between placement and settlement, it is advantageous for all corporate bonds to be announced at the end of the month. Thus a "fixed calendar" system has developed for corporate bonds -- and, by default, for public bonds as well since they are issued when corporate bonds are not.

Rating corporate bonds and determining their terms were issues in Japan until just recently. A four-grade rating system (B, BB, A and AA) looked only at certain financial ratios of the issuer, including net assets and its net worth to total capital ratio, and compared them with uniform standards. The rating derived from this comparison determined the terms of the issue, which were non-negotiable (see Table 2). Clearly this system drives a wedge between the market's evaluation of the soundness of a company as expressed in its stock price and the company's bond worthiness. At the urging of the Ministry of Finance, Japanese banks and securities companies set up an independent bond rating company in 1986. Although many firms were initially reluctant to provide the proprietary information necessary for accurate evaluations, most financial institutions have agreed to participate in the system, providing a single, comprehensive source of credit information. With the adoption of a grading system comparable to this country's, which indicates the degree of certainty of payment of principal and interest, the Japanese market is well on its way to conforming with de facto international standards.

As far as the variety of bonds available, straight, secured bonds have been the favored instrument, mainly because regulations and business practices have limited other forms. Convertible bonds, which can be turned into shares

of the issuing company under specific conditions, have been available since 1938, but they are not often chosen because of strict qualification requirements even though they have the advantage of a lower coupon compared with a straight bond. In the 1970s the first unsecured convertible bond was issued (1973) and notes with maturities ranging from six to 15 years (rather than the standard 10) were offered.

Table 2: Terms of Corporate Bond Issues

(as of March 1987)

<u>Rating</u>	<u>Maturity (years)</u>	<u>Coupon Rate (percent)</u>	<u>Issue Price (yen)</u>	<u>Yield (percent)</u>
AA	12	5.3%	¥99.50	5.368%
	10	5.3	99.75	5.338
A	12	5.4	99.50	5.469
	10	5.4	99.75	5.438
BB	12	5.5	99.50	5.569
	10	5.5	99.75	5.538
B	10	5.6	99.75	5.639

Source: Nomura Research Institute

Warrant bonds, which give the holder the right within a certain period to demand that the company issue new stock and buy it at a predetermined price, were introduced in 1981 at the request of the financial community. This instrument offers advantages to both the issuer and the buyer. It is less costly to issue since it carries a lower coupon. It can be more lucrative for the buyer since he has the opportunity to collect dividends if the warrants are exercised and also to earn capital gains if the stock is eventually sold. The issuing company can benefit as well from new stock issues initiated by warrant holders since the general public then has a chance to buy stock in a firm that may be thinly traded. Warrants have proved mildly popular, although a self-imposed industry restriction against separating warrant rights from the underlying bond (as is often done here, meaning brokers sell both parts) has limited their appeal.

Because of some initial improprieties when a Western-style financial system was first introduced in Japan, a security to back a bond issue has been a standard requirement since the 1920s. This restriction made sense during the immediate postwar years when many firms were financially shaky, but its rationale has eroded as the economy has prospered. Companies that are financially strong are required to behave just like weak companies, translating into high up-front costs. Companies in certain lines of business, particularly trading companies, can find it very difficult to provide security since they have few tangible assets. And finally, a Japanese company planning to float a bond overseas (where unsecured bonds are the norm) might earn a low credit rating because of its history of offering only secured bonds at home.

Under increasing pressure from domestic firms, the Ministry of Finance has liberalized the security requirements, making major changes at least once a year since 1983. As a result, the number of firms eligible to float unsecured bonds rose from 30 in 1983 to about 180 in early 1987 and to approximately double that number today. This change has been a major factor behind the boom in convertible bonds.

A bond repurchase agreement, or gensaki transaction, is a short-term financing ploy; the bond seller agrees to repurchase the bond at the end of a certain period of time, usually for a higher price. The bond seller gets to use the cash for the specified period, while the bond buyer is assured of a profit. Through the 1970s this form of bond trading was extremely popular because it was one of the few instruments that offered a market-determined interest rate; moreover, it was open to a wider range of customers, including foreigners. As much as half of all bond transactions were gensaki exchanges by the late 1970s. The proportion has declined, however, as other market-interest instruments have become available.

Nevertheless, gensaki trades will remain a major feature of the market for several reasons. Securities companies use gensaki deals to finance much of the inventory of stocks they need to complete stock trades. Second, foreign institutions, private businesses and certain types of credit unions are barred from participating in the other two major short-term money markets, the call and discount markets. Therefore, the gensaki market is their only source of short-term finance. Smaller banks and other similarly sized financial institutions have also made increasing use of the gensaki market since they find it difficult to operate in markets used by larger firms. Deregulation of interest rates and liberalization of markets will continue to whittle away at the gensaki market, but it is unlikely that it will be reduced to a minor role.

Foreign Frenzy

Pacing the liberalization of the domestic market, there has been a surge of activity in foreign bond markets and in bonds denominated in foreign currencies. The Finance Ministry opted to liberalize Euroyen markets before domestic markets to give Japanese financial firms a chance to experiment with the rough and tumble of free markets overseas before setting them loose at home. As deregulation has progressed in both markets, a host of new debt instruments has been created bearing colorful names such as sushi and harakiri bonds. (See the Appendix for an explanation of the various types of new bonds.)

Deregulation of the domestic market for yen-denominated bonds proceeded one step behind the decontrol of Euroyen markets, with the result that the domestic market languished. Foreign governments and agencies have been able to float yen-denominated issues in Japan (so-called samurai bonds) since 1970, and the growth of the market was steady if unspectacular until 1985. The Euroyen market, on the other hand, has enjoyed explosive growth (Tables 3 and 4). There were only 15 samurai bond issues worth Y420 billion (\$3.4 billion at Y125=\$1.00) in 1987 compared with 149 Euroyen market issues totaling Y2.9 trillion (\$23.2 billion) the same year.

Table 3: Inward and Outward Bond Flotations, FY 1970-FY 1987*

(in millions of dollars)

<u>Fiscal Year</u>	<u>Flotation of External Bonds by Residents</u>	<u>Flotation of Bonds in Japan by Non-Residents</u>
1970	\$122	\$0
1971	55	0
1972	31	0
1973	22	0
1974	446	0
1975	1,565	0
1976	1,577	0
1977	1,378	0
1978	2,749	0
1979	3,320	1,441
1980	3,654	1,407
1981	5,707	3,500
1982	6,812	3,651
1983	9,690	3,271
1984	13,876	5,237
1985	16,047	6,751
1986	25,579	3,812
1987**	32,511	2,902

*Balance of payments basis.

**April 1987-January 1988 only.

Source: Ministry of Finance

The imbalance is widening even though Tokyo has equalized the regulations governing the terms of offer and the flotation qualifications between the two markets. Residual controls on domestic bond flotations are the main reason. The amount of paperwork and time necessary to float a yen-denominated bond in Japan far exceed those in the Euroyen market -- up to 60 days versus a week. Regulations governing settlement and delivery of securities also reduce flexibility. In addition, the secondary market for samurai bonds remains very thin, making the bonds illiquid and curtailing their attractiveness. The Big Four brokerage houses -- Daiwa Securities Co., Ltd., Nikko Securities Co., Ltd., Nomura Securities Co., Ltd. and Yamaichi Securities Co., Ltd. -- agreed to begin market-making activities in June 1986 in an effort to energize the secondary market and breathe life back into the primary market. Although the Big Four are a major force in Japan, there are about 30 market makers in the Euroyen market, keeping the secondary market there very active and competitive.

Domestic and foreign companies have naturally gravitated to the market that offers the greatest flexibility and lowest costs. Tokyo is in the process of devising a response to this situation, with implementation of a shelf-registration system in October as the first step. Shelf registration allows an issuer to prepare the paperwork for a certain amount of bonds at one time but float them at any time during a certain period. Thus, an entire year's worth

of borrowing can be cleared at one time and the issues put on the "shelf," ready to be floated when market conditions are favorable. This system, which is in place in the United States and Europe, will certainly help but does not address all the problems.

Table 4: External and Internal Bond Offerings, FY 1982-FY 1987*

(in billions of yen)

a. external bonds issued by residents

Fiscal Year	Foreign Currency- Denominated Bonds		Euroyen Bonds		Total	
	Number	Amount	Number	Amount	Number	Amount
1982	n.a.	n.a.	n.a.	n.a.	202	Y1,650.4
1983	n.a.	n.a.	n.a.	n.a.	280	2,357.4
1984	337	Y3,288.5	0	0.0	337	3,288.5
1985	345	3,630.6	17	Y302.0	362	3,932.6
1986	431	4,408.6	17	435.0	448	4,843.6
1987**	114	1,610.2	6	200.0	120	1,810.2

b. bonds issued in Japan by non-residents

Fiscal Year	Foreign Currency- Denominated Bonds		Euroyen Bonds		Total	
	Number	Amount	Number	Amount	Number	Amount
1982	n.a.	n.a.	n.a.	n.a.	72	Y877.0
1983	n.a.	n.a.	n.a.	n.a.	65	794.0
1984	0	0.0	71	Y1,253.0	71	1,253.0
1985	11	Y298.6	62	1,350.0	73	1,648.6
1986	13	224.7	30	490.0	43	714.7
1987**	1	11.4	11	213.0	12	224.4

*Notification basis.

**April-June 1987 only.

Source: Ministry of Finance

In the meantime, the samurai market is becoming a rich source of yen funds for developing countries, especially Asian neighbors. These smaller nations are generally unable to meet the competitive conditions in the Eurobond market but have found an acceptable alternative in samurai bonds. Tokyo could encourage this trend as part of its efforts to play a greater role in supporting the global economy.

Commercial Paper

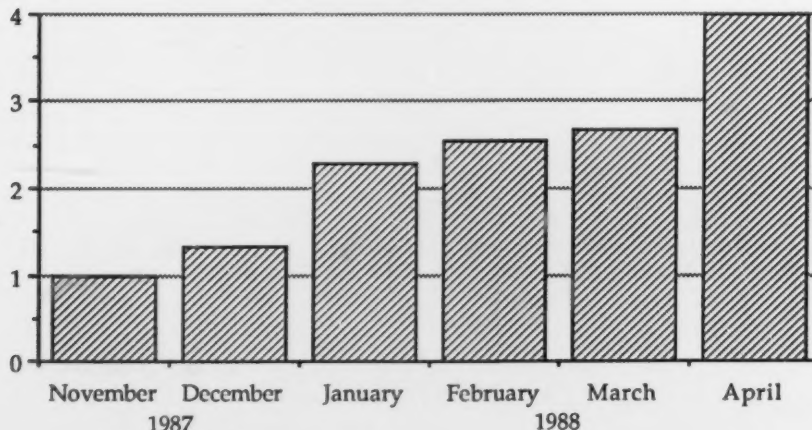
The latest innovation to appear on Japanese debt markets is commercial paper. The CP market was developed in the United States as a convenient means for companies to raise cash for short- and medium-term requirements. CP is an unsecured pure debt instrument issued directly by the borrower and backed only by its promise to repay. Although CP generally carries a slightly higher interest rate, the ease and rapidity with which it can be issued and money saved by not paying for trustees or underwriters more than compensates for this cost.

The Finance Ministry viewed the CP market as too risky and speculative until just last year. Even when the market opened November 20, 1987, the Ministry imposed some rules that caused analysts to question the outlook for the new instrument. Only firms currently qualified to float unsecured bonds (360 or so) are eligible to issue CP. The minimum denomination was set at ¥100 million (\$800,000) and the maturity restricted to between one and six months. Banks and securities companies must underwrite the new instrument. Finally, only 53 major companies can issue unconditional CP; the remaining firms' CP must be guaranteed by the underwriter. The only advantage CP retains over conventional bonds is the speed of issue; bonds take at least 30 days to arrange while CP can be floated in as little as a few days.

The CP market has surprised analysts in its first six months of operation by surpassing even the optimistic expectations of the Finance Ministry. The outstanding balance at the end of April was estimated to be nearly ¥4 trillion (\$32 billion), thanks to a ¥1.7 trillion surge in issues during that month (see Figure). With the average interest rate on a three-month note at 3.9 percent, CP is well below the average three-month certificate of deposit (4.3 percent), above the short-term prime rate (3.4 percent), and on a par with the bill discount rate (between 3.8 and 4.3 percent). For highly qualified firms, the CP market is becoming analogous to the interbank market -- a highly liquid market that allows optimal use of cash on hand. Although the market is still restrictive by U.S. standards, its first few months of operation have been an unqualified success.

Japan's Commercial Paper Market

(balance in trillions of yen at end of month)



Source: Nihon Keizai Shimbun

Breaking the Bonds

Market watchers agree that the introduction of a shelf-registration system is the biggest change on the horizon. It could give a major boost to the straight bond market as well as the samurai market if the legislation is adopted in time. Tokyo has been taking other steps, however, in an effort to make the Japanese market more attractive and open.

- The Ministry of Finance reduced the period between registration of a bond issue and its flotation from 30 days to 15 on April 1. This applies to all types of bonds. Samurai bonds, however, still have an extra step between registration and issue, meaning the waiting period has been cut from 60 days to 45. MOF hopes this step will make it easier for borrowers to match offer terms with expected market conditions.

- MOF has been relaxing the qualifications required to issue unsecured bonds. Although nearly 400 firms presently have this right, this number is still a fraction of the nearly 3,000 publicly traded companies in Japan. As the unified credit rating system matures, MOF can be expected to lower its criteria for unsecured issues.

- A broader range of maturities and rates is passing MOF inspection. The minimum maturity was six years; it can now be as short as four. Five-year notes are prohibited to prevent competition with the long-term credit institutions, which rely on five-year debentures for much of their fund-raising. Liberalization of interest rates is also spreading to bonds as MOF has approved some floating-rate issues.

- The postal savings system won the right April 1 to sell government bonds over the counter as a partial offset for the elimination of most tax-exempt savings accounts, which form a major share of postal savings funds. With thousands of offices around the country, this change could have a significant impact on the secondary bond market. Postal officials are satisfied with the results so far, but plan no major campaign to take business away from securities dealers or commercial banks.

- The Finance Ministry hopes to change the current practice of rotating the position of lead underwriter on government bonds among the Big Four securities firms. A system of competitive bidding will be phased in over the next year or so.

- MOF is also considering dropping the requirement that a bond issuer commission a commercial bank to act as trustee. Borrowers complain that this Japanese practice adds to the cost of flotation, noting that no trustee is needed in the American or European markets. The "commission bank" system is a sensitive point with MOF since commercial banks naturally oppose any change.

- While domestic commercial banks are allowed to underwrite some government bond issues, handle some private domestic placements and participate fully in foreign corporate bond markets (through overseas subsidiaries), they are still barred from acting as lead manager for a foreign flotation by a domestic corporation. The Finance Ministry has begun negotiations with banks and securities companies to end this restriction. Brokerage houses, however,

are demanding a high price for greater freedom for banks; they want access to foreign exchange trading, relaxed flotation criteria, an end to the commission bank system and universal adoption of the U.S. bond credit rating system.

- Finance is planning to computerize and centralize the secondary bond market beginning in July. The Japan Bond Trading Co., Ltd., a clearing house set up by domestic brokerages, will become the central trading location for government, corporate and foreign bonds. Computers and telecommunications facilities will be installed to insure that uniform, real-time quotations are available to all parties. In addition, MOF will drop the registration system for the secondary market, reducing the time and paperwork involved in settling transactions.

These changes will certainly help bring the Japanese bond market closer to global standards. Although foreigners have welcomed these moves, they argue that more needs to be done, especially in light of the major presence the Japanese are building in overseas bond markets. This view is particularly widespread in the United States, where Japanese investors buy as much as one-half of the U.S. Treasury bonds offered at any one auction and where Japanese firms control several primary government bond dealers.

Bond Bashing

The basic issue is that American financial firms, especially securities houses, want an enlarged presence in the primary Japanese government bond market in order to make more money and enhance their prestige. The syndicate system creates a fixed pie, however, so that an increase in the share for foreigners can only come at the expense of domestic firms. Naturally, Japanese companies oppose any redivision of the pie, arguing that they supported the system during the years when it was unattractive to participate. The Ministry of Finance is ambivalent since the system works so well.

Among the 30 foreign brokers and 34 overseas banks that currently have a stake in the syndicate, Salomon Brothers Inc.'s Japanese subsidiary is the most active and vocal. It has been a syndicate member longer than any foreign firm and has the largest share -- 1 percent. The 5.721 percent share for all foreign securities companies is small compared with the total for Japanese securities firms (26.1 percent) or banks (about 45 percent). Of all the central government securities issued in fiscal 1987 (ended March 31, 1988), about 37 percent was distributed through the syndicate, 34 percent was placed in official accounts, and the remaining 29 percent (mostly short-term notes) was sold by auction.

In an effort to head off conflict, Tokyo instituted a mixed auction/syndicate system in the last quarter of 1987. All 20-year bonds are now placed by auction, much like the system used in the United States. In addition, one-fifth of the 10-year bonds are offered through a non-competitive bidding system. Interested parties submit bids to the ministry immediately before the terms for the bonds to be issued through the syndicate are set. Although each firm may bid for whatever amount it wants, a limit of 1 percent of the offering is awarded to any one company. At the first auction of 10-year bonds under the new system, foreign firms won 16.6 percent. Foreign participation in the 20-year bidding has been mixed depending on the attractiveness of the terms.

In addition, the government has relaxed the qualifications required for foreign firms to participate in the auction of two-, three- and four-year bonds.

This is not enough to quiet foreign firms. They -- and major domestic players -- want the government to use an open auction system for all types of bonds. Smaller companies oppose this change since they would probably be unable to compete. It is an open question in Japan whether foreign firms could compete effectively against the major Japanese banks and securities companies with their well-developed client base, which insures that bonds can be placed quickly and profitably in the hands of investors. Given the vast resources available to the biggest Japanese firms, even the largest, most determined foreign firm could be outbid.

The Finance Ministry's response is likely to be a gradual rise in the syndicate share for foreigners and increased use of auctions for 10-year bonds. While this will delay a shakeout, small firms already see the handwriting on the wall and are beginning to merge while they still have a choice. It is unclear whether foreign firms will be satisfied with MOF's tried-and-true incremental approach. The danger is that Washington will not be patient and officially or unofficially begin to restrict Japanese access to U.S. financial markets. Delayed approval of Japanese purchases of U.S. primary dealers by the Federal Reserve Board has already raised fears in Japan that the squeeze may be on. Such restrictions, however, are like cutting off one's nose to spite one's face since the United States will remain dependent on foreign funds to finance the giant federal budget deficit for many years to come. For its part, MOF must balance everyone's interests in reforming the government bond system. This assures that changes will come slowly and gradually.

Conclusion

Given Japan's giant surplus of savings, it is interesting that liberalization of domestic bond markets has not been a very high priority for the Finance Ministry. Japanese investors have been willing to accept the risk of participating in foreign markets by sending their money abroad, substituting for foreign borrowers coming to Japan. The fact that Japanese investors run the risk of exchange rate shifts makes the massive outflow of funds over the past several years all the more amazing. The good luck, however, cannot last. Should Japanese investors lose interest in foreign markets (for whatever reason), the opportunities for foreigners to seek financing in Japan's rich financial markets must be as varied as possible. If the nation is to become a fully rounded financial center and play a major role in supporting global development, bond market reform must proceed.

For further information, contact Jon Choy.

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The views expressed in this report are those of the author and do not necessarily represent those of the Japan Economic Institute.

Appendix: A Glossary of Japanese Debt Instruments

Aome bond - A general term for all bonds issued in the Japanese market by foreigners, even other Asians. The literal translation is "blue-eyed" bond. The opposite of kurome bonds.

Earthquake bond - Bonds redeemable in the event of a natural disaster. Earthquakes are a constant threat in Japan, and this instrument was developed to placate concerned investors.

Geisha bond - Foreign-currency bonds privately placed in Japan by foreigners. The first issue of geishas was in June 1985; it was denominated in European Currency Units.

Harakiri swap - A Euromarket transaction where a Japanese company issues a dollar-denominated bond and swaps the proceeds with a Japanese institution, usually a bank, for yen debt at a specified exchange rate and interest rate. If the interest rate on the yen debt is higher than the rate the Japanese company pays in a regular fund-raising operation, the exchange appears to have been made at money-losing terms, thus the use of the Japanese term for ritual suicide. While most observers see this tactic as a means of buying market share, it is possible to break even or turn a small profit by further swapping the floating-rate dollars for fixed-rate ones and waiting for an advantageous exchange rate.

Heaven-or-hell bond (Tengoku-jigoku bond) - These are bonds denominated in dollars but paying interest in yen. The principal is furthermore linked to the yen-dollar exchange rate at the time of maturity: the lower the yen, the higher the redeemable value; the stronger the yen, the lower the value. When first offered by Nomura's European subsidiary, exchange rates of Y180 to Y160 were the break-even points. Obviously if the investors were to cash in these bonds today, it would be a hellish experience. If the yen falls far enough by the time the bonds mature in another few years, however, investors may think they are in heaven. This instrument is targeted at people interested in speculating on exchange rates.

Kagonuke lease - Japanese leasing companies are barred from offering yen-denominated loans to foreigners. The kagonuke ("slip out of a cage" or "escape through the back door") lease has been devised as a way around this barrier. The assistance of a foreign bank as intermediary is necessary. The bank simultaneously arranges a Euroyen loan for the foreign borrower and leases some sort of asset (such as old capital equipment) from the Japanese leasing firm. The bank assigns the Euroyen credit to the leasing company, which then cancels the bank's lease obligations. The net effect is that the leasing company ends up receiving the interest payments of the foreign borrower in exchange for its yen. The practice is a sensitive point among banks, the Finance Ministry and leasing companies since the kagonuke rates are generally well below what banks can charge.

Kamikaze swap - This maneuver is identical to the harakiri swap, but it is initiated by a foreign firm in the Japanese market.

Kurome bond - A general term for any bond issued by a Japanese company in the Japanese market. The opposite of an aome bond.

Natto bond - See sushi bond below.

Reverse harakiri swap - The mechanics of the transaction are the same as a harakiri swap, except that the currencies are reversed -- a Japanese bank swaps dollars for the the yen funds raised through a bond issue (domestic or international) by a Japanese entity.

Samurai bond - These are bonds denominated in yen and issued in the Japanese market by foreign entities. The first samurai bond was placed in 1970. Issuers were initially restricted to foreign international institutions or foreign sovereign governments; today, however, a credit rating of just single-A is required. Since 1986 innovations such as dual-currency samurais have been offered to keep the market active.

Samurai lease - Developed by the Bank of Japan in 1978, this instrument involved low-interest yen loans by the Export-Import Bank of Japan to domestic leasing companies, which in turn would use the funds to purchase foreign equipment with sales contracts denominated in dollars. It was hoped that this would encourage imports and give leasing companies a chance to try their hand at complex international finance and cross-border leasing. The program lasted only one year.

Shogun bond - These are similar to samurai bonds except that they are denominated in a foreign currency rather than yen. The World Bank inaugurated this innovation in 1985, raising approximately \$300 million. Subsequent issues have been denominated in Canadian, Australian and American dollars.

Shogun lease - This is a yen-denominated, cross-border lease. For foreign firms with significant yen income, this instrument provides a hedge against exchange rate changes. Comparatively low rates are another advantage.

Sushi bond - This is a bond issued by Japanese firms in the Euromarket. It is denominated in a foreign currency but intended for Japanese buyers. The generally low coupon makes them unattractive to foreign buyers, but they are still palatable to Japanese insurance companies and other institutional investors. In the past these investors got around the ceiling on investments in foreign-issued foreign bonds by purchasing sushi bonds. Since the overseas investment ceiling was raised significantly in 1986, demand for sushi bonds has dropped sharply. The more apt name for this instrument, natto bond, is derived from a pungent, sticky fermented soybean food that foreigners (and even many Japanese) find unappetizing.

Tengoku-jigoku bond - This is the Japanese name for heaven-or-hell bonds (see above).

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J A P A N · E C O N O M I C · I N S T I T U T E

J E I

R E P O R T

A Two-Part Report: A and B

NO. 22B

June 10, 1988

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Japan Top Creditor Again

Japan has picked up another economic trophy, this one for the third straight year. As of December 31, 1987 it had net foreign assets of \$240.7 billion, up from \$180.4 billion a year earlier (see Table 1). Analysts expect Britain, which Japan edged narrowly last year for the top spot, to be the runner-up again, although the latter has not yet released its statistics.

The United States finds itself in the opposite, if until recently unaccustomed, role of the world's largest debtor. Its 1987 net indebtedness to the rest of the world is likely to be around \$400 billion, ahead even of major Latin American borrowers. As recently as 1984 the United States was a net creditor, with its net foreign assets peaking in 1981.

Table 1: Japan's Net External Assets

(in millions of dollars)

<u>End of Year</u>	<u>Private Sector</u>	<u>Government Sector</u>	<u>Total</u>
1978	\$-2,550	\$38,764	\$36,214
1979	850	27,927	28,777
1980	-16,659	28,193	11,534
1981	-18,537	29,455	10,918
1982	2,046	22,636	24,682
1983	11,928	25,331	37,259
1984	47,069	27,277	74,346
1985	104,450	25,371	129,821
1986	138,541	41,810	180,351
1987	146,494	94,250	240,744

Source: Bank of Japan and Nihon Keizai Shimbun, May 25, 1988.

The position of the world's two largest market economies comes as no surprise. The mirror image of Japan's continuing large current account surpluses is large net foreign investments. Similarly, the United States in effect pays for its excess of imports over exports by getting deeper in hock to foreign lenders. Put somewhat differently, Japan's ever-stronger creditor position was predictable from the previously announced large 1987 current account surplus (see JEI Report No. 6B, February 12, 1988).

Estimated 1987 U.S. data suggest that Japan has a net asset position with the United States of about \$90 billion, although this figure may be distorted by not reflecting flows between the United States and Japan routed through third countries. If reasonably accurate, the number indicates that Japan accounts for about one-fourth of this country's net debtor position, leaving the United States with many other creditors and Japan with other debtors.

A closer look at the new Japanese data suggest more complexities (see Table 2). Japan's overseas investments were up, to be sure, but long-term liabilities surged as well, reflecting the on-going process of internationalizing Japanese capital markets. Foreign investors bought more Japanese bonds and Japanese firms floated more issues abroad in 1987, contributing to the 22.8 percent increase in long-term liabilities.

Short-term private assets were also up dramatically. Accounting for most of the jump was a big increase in the amount of funds Japanese firms transferred to their overseas affiliates, which in turn often invested in higher-paying certificates of deposit and commercial paper than are available in Japan. More generally, the increase in both overseas short-term liabilities and assets was attributable to Tokyo's offshore market, which was established in late 1986 and grew dramatically in 1987.

Direct investment abroad, the means by which Japanese companies invest in production facilities, distribution operations and real estate, among other

things, was 32.6 percent greater at the end of 1987 than just a year earlier at \$77 billion. Investment in securities remained far larger, however, increasing 31.7 percent to \$339.7 billion. This suggests that most Japanese foreign investment income is likely to continue to be interest income rather than profits.

Table 2: Japan's External Assets and Liabilities

(in millions of dollars)

	<u>Assets</u>		<u>Liabilities</u>	
	<u>End of</u> <u>1986</u>	<u>End of</u> <u>1987</u>	<u>End of</u> <u>1986</u>	<u>End of</u> <u>1987</u>
Long-term	\$476,136	\$646,181	\$192,336	\$236,181
Private sector	424,704	565,100	152,192	178,810
Government sector	51,432	81,081	40,144	57,371
Short-term	251,170	425,450	354,619	594,706
Private sector	207,876	343,261	341,847	583,057
Government sector	43,294	82,189	12,772	11,649
Total	727,306	1,071,631	546,955	830,887

Source: Nihon Keizai Shimbun, May 25, 1988.

Japan's position as the world's largest creditor is likely to have major effects. It will probably boost Japan's role as the top earner of investment income, which in turn will prop up the current account surplus (see JEI Report No. 18B, May 6, 1988). Japanese banks, insurance firms and securities companies, already among the world's largest, are likely to see even more business come their way as Japanese individuals and firms, following the practices of their American counterparts, favor homegrown financial service firms to invest overseas and to manage the funds already there.

Douglas Ostrom

Japan Gets A New Economic Plan

New economic plans in Japan are almost inevitable when the government changes hands. Now, just in time to explain to other world leaders at the upcoming Toronto economic summit, Prime Minister Noboru Takeshita has his, a document setting out the goals of policymakers and the likely course of the economy over the next five years. It is scheduled to run from April 1 of this year through March 31, 1993. The new plan, the eleventh in the postwar period, has a theme instead of a name, "Japan Living Together with the World." It replaces the "Outlook and Government Outline for the 80s" adopted by the Nakasone cabinet in August 1983.

Unlike the plans of communist countries, which actually serve as guidelines for the detailed direction of the economy, Japanese plans are short on prescriptions or implementing mechanisms. Rather than government edict, Japan

to convene a special international conference on verification of nuclear testing. British representatives were hopeful that Japan's expanded support for U.N. peacekeeping missions would extend to the forces on Cyprus. The prime minister was quoted as saying that this positive feedback helped him to appreciate the "global aspirations for peace and disarmament."

Barbara Wanner

Foreign Minister To Visit Israel

Foreign Minister Sosuke Uno will travel to Jerusalem late this month during a tour through the Middle East. The decision to include Israel in his itinerary has been interpreted as a sign that Tokyo may be shifting away from its tilt toward Arab nations. More generally, analysts believe the visit reflects Japan's awareness of its global status, including the need to display a foreign policy that is at least partially independent from economic concerns.

If so, this would be a dramatic shift since Japan's position on Arab-Israeli disputes has been based almost exclusively on economic considerations. Support for Palestinian self-determination and Israel's withdrawal from territories occupied during the 1967 war have been the main themes of Japan's Middle East policy ever since 1973. At that time members of the Organization of Petroleum Exporting Countries threatened to cut off oil sales to countries that were "unfriendly" to the Arab cause.

Indeed, some Japanese companies reportedly comply with Arab demands that they boycott the Israeli market. Tokyo has never endorsed the practice but neither has it taken action to prevent the private sector from adopting such policies. (The United States, by contrast, has anti-boycott legislation.) The Washington Post quoted one Foreign Ministry official who admitted that some Japanese firms hesitate to anger Arab customers by selling to Israel: "When you sell, the population has to be counted."

Not surprisingly, Japan's trade relations with Arab countries as a group have been much closer than those with Israel. But its two-way trade with several non-oil producers is no greater than that with Israel. Israel's market for Japanese goods is substantial but remains largely unexplored (see Table).

Government officials in Tokyo have downplayed the potential significance of Mr. Uno's visit, apparently in an attempt to maintain smooth relations with Arab friends. Some have said that the trip merely reflects the potential for improved trade relations, not political questions. Others say that the visit is simply a continuation of present diplomatic efforts. The foreign minister will also visit Egypt, Jordan and Syria. He reportedly also hopes to meet with Palestine Liberation Organization leader Yasser Arafat and to visit Palestinian sections of the Israeli-occupied West Bank.

Nonetheless, the fact that Mr. Uno is going to Israel is a significant step forward. Certainly, Israeli officials are encouraged. One official was quoted by the Washington Post as saying that the visit is "a sign of Japan's maturity in the international arena. They came to the conclusion that they have to at least listen to all sides."

Eileen M. Doherty

Japan's Exports to Middle East Countries, 1983-87

(in millions of dollars, f.o.b. value basis)

<u>Country</u>	<u>1983</u>	<u>1984</u>	<u>1985</u>	<u>1986</u>	<u>1987</u>
Saudi Arabia	\$6,687	\$5,634	\$3,890	\$2,762	\$3,239
United Arab Emirates	1,357	1,126	1,164	1,033	1,118
Iran	2,820	1,692	1,348	1,144	1,043
Kuwait	1,763	1,432	1,536	1,220	857
Egypt	851	975	731	562	544
Iraq	631	806	1,306	1,210	391
Qatar	233	175	164	148	150
Jordan	293	205	190	183	142
Syria	250	116	127	91	131
Israel	267	174	170	275	346
Total Exports to Middle East	17,160	14,206	12,171	9,795	9,177

Source: Japan Tariff Association

Notes

South Africa - The African National Congress opened a representative office in Tokyo May 25. The office will solicit financial, political and diplomatic support from Japan in the fight against Pretoria's apartheid policy and will act as coordinator of the ANC's efforts in East Asia. Spokesman Jerry Matsila has urged Japan to "rethink" its South Africa policies. Although Tokyo has initiated a number of sanctions against Pretoria, Japan was South Africa's largest trading partner in 1987 (see JEI Report No. 7B, February 19, 1988). Mr. Matsila argued that "the notion that business is business and not politics is totally unacceptable."

In a related development, Zimbabwe President Robert Mugabe encouraged Tokyo June 1 to take stronger measures against apartheid. One way to do so, he said, would be to pump economic assistance into other African nations while making a "real political thrust" against South Africa -- that is, severing economic ties. He complained that Japan's attempt to disassociate itself economically from Pretoria "has taken it some time, if it is doing that at all" and argued that additional economic sanctions would show that Tokyo is "sensitive to the downtrodden people who are fighting for the right to self-determination."

President Mugabe's call came shortly after a meeting between Prime Minister Noboru Takeshita and Mozambique President Joaquim A. Chissano May 23 in Tokyo. Mr. Takeshita reaffirmed Tokyo's opposition to apartheid, promising to "positively take part in discussions" when the issue is raised at the June 19-21 economic summit in Toronto. He pledged a \$16 million general-purpose loan for Mozambique -- not only to promote the country's development goals, but

STATISTICAL SUPPLEMENT

13

Trade and Payments Data
(in millions of dollars unless otherwise indicated)

	1986	1987	January- March 1987	January- March 1988	January 1988	February 1988	March 1988
Japan's Balance of Payments							
Trade Balance	\$92,827	\$96,386	\$23,373	\$21,268*	\$4,583*	\$7,441*	\$9,244*
Exports (f.o.b.)	205,591	224,605	50,515	59,299*	17,000*	19,866*	22,433*
Imports (f.o.b.)	112,764	128,219	27,142	38,031*	12,417*	12,425*	13,189*
Current Account Balance	85,845	87,015	20,962	18,487*	3,515*	6,849*	8,123*
Long-Term Capital (net)	-131,461	-136,532	-32,209	-15,305*	-3,785*	-8,272*	-3,248*
Overall Balance	-44,767	-29,545	-4,872	8,694	5,689	-1,762	4,767
International Reserves (end of period)	42,239	81,479	58,389	84,857	83,407	83,821	84,857
Japan's Customs Clearance Trade							
Trade Balance	82,743	79,706	19,487	15,797	3,083	5,255	7,459
Exports (f.o.b.)	209,151	229,221	51,464	60,296	17,331	20,245	22,721
Cars	32,945	35,693	7,477	8,981	3,089	3,017	2,875
Steel	12,706	12,610	2,837	3,292	925	1,082	1,284
Imports (c.i.f.)	126,408	149,515	31,977	44,499	14,247	14,990	15,262
Crude Oil	19,481	20,663	5,338	5,744	1,952	2,024	1,768
Japan-U.S. Trade							
Trade Balance	51,401	52,090	11,015	9,772	2,976	3,401	3,395
Exports (f.o.b.)	80,456	83,580	18,001	19,859	5,851	6,822	7,187
Imports (c.i.f.)	29,054	31,49	6,986	10,088	2,874	3,421	3,793
U.S.-Japan Trade							
Trade Balance (f.a.s./c.i.f.)	-58,575	-59,825	-14,373	-13,023	-3,946	-4,531	-4,545
Exports (f.a.s.)	26,882	28,249	5,959	8,837	2,668	2,937	3,232
Imports (c.i.f.)	85,457	88,074	20,331	21,860	6,614	7,468	7,777
Trade Balance (f.a.s./Customs)	-55,030	-56,326	-13,571	-13,571			
Exports (f.a.s.)	26,882	28,249	5,959	5,959			
Industrial Supplies	8,752	10,156	2,269	2,269			
Capital Goods	6,728	7,769	1,510	1,510			
Food and Feed	5,043	5,555	1,129	1,129			
Consumer Goods	1,690	2,551	522	522			
Imports (Customs)	81,911	84,575	19,529	19,529			
Automotive Products	32,849	33,695	7,748	7,748			
Capital Goods	25,334	28,947	6,626	6,626			
Consumer Goods	15,451	13,385	3,054	3,054			
Industrial Supplies	6,949	7,281	1,808	1,808			

The Commerce Department has not released
any end-use data for 1988.

*Preliminary

STATISTICAL SUPPLEMENT

Japanese Economic Indicators

(percent change from year-earlier period unless otherwise indicated)

	<u>1986</u>	<u>1987</u>	<u>January- March 1987</u>	<u>January- March 1988</u>	<u>January 1988</u>	<u>February 1988</u>	<u>March 1988</u>
<u>Discount Rate (end of period)</u>	3.0%	2.5%	2.5%	2.5%	2.5%	2.5%	2.5%
<u>Outstanding Money Supply</u>	8.7%	10.4%	8.8%	12.0%	11.9%	12.4%	11.8%
<u>Industrial Production</u>	-0.2%	3.0%	0.2%	11.0%	9.2%	12.2%	11.4%
<u>Manufacturing Operating Rate</u>	-4.6%	0.5%	-3.1%	6.6%	7.0%	7.4%	5.4%
<u>Number of Bankruptcies</u>	-7.1%	-27.6%	-14.4%	-22.9%	-25.1%	-23.2%	-20.7%
<u>Residential Construction Starts</u>	10.4%	22.7%	12.3%	16.8%	19.0%	17.1%	14.8%
<u>Job Openings to Applications (ratio)</u>	0.62	0.68	0.62	0.88	0.86	0.88	0.90
<u>Nominal Wages</u>	2.7%	1.9%	2.0%	2.4%*	0.8%	3.3%	3.1%*
<u>Labor Productivity</u>	2.3%	6.7%	2.0%	n.a.	n.a.	n.a.	n.a.
<u>Wholesale Prices</u>	-9.1%	-3.7%	-7.9%	-1.0%	-1.0%	-1.0%	-1.0%
<u>Consumer Prices</u>	0.6%	0.1%	-0.9%	0.8%	0.9%	0.7%	0.7%
<u>Yen-Based Export Prices</u>	-15.1%	-5.1%	-7.6%	-5.6%	-6.4%	-5.2%	-5.0%
<u>Yen-Based Import Prices</u>	-35.8%	-8.3%	-27.5%	-3.9%	-3.3%	-4.3%	-4.2%

*Preliminary

For Japan's most recent GNP figures, see JEI Report No. 12B, March 25, 1988.

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J E I

R E P O R T

A Two-Part Report: A and B

NO. 23A

June 17, 1988

THE CHANGING NATURE OF JAPANESE MANUFACTURING

Summary

The economic world knows Japan mainly through its manufactured products. And companies such as Toyota Motor Corp. and Sony Corp. are the best known. This report, based mostly on the latest (1985) Japanese census of manufactures, is the story of how these companies fit into the broader mosaic of Japanese manufacturing. Just as there are winners and losers among companies, some Japanese industries have been more successful than others.

The era of the high yen as well as internal dynamics continue to pose new challenges for Japanese manufacturers. Firms are seeking opportunities where they can find them, venturing increasingly into manufacturing abroad or into new activities at home. These changes promise to keep the structure of Japanese manufacturing fluid and dynamic.

Trends in Industrial Structure

Manufacturing looms large in the Japanese economy but it is not of overwhelming importance. During the postwar period it has never employed more than about one-third of the non-agricultural labor force, reaching a peak of 32 percent in 1970 before drifting downward. In recent years manufacturing employment has remained a stable percentage of total employment (see Table 1).

A remarkably large number of locations are involved in manufacturing activity in Japan. The data in Table 1 refer only to those workplaces where at least four people are employed but there are still almost half a million such locations. Furthermore, this striking characteristic of Japanese manufacturing

shows few signs of changing. Different ways of collecting the data make comparisons difficult, but the number of manufacturing workplaces employing 10 or more people increased from 163,487 in 1967 to 184,923 in 1985. In 1985 a Japanese worker was more likely to work in a factory employing fewer than 10 people than in one employing more than 1,000.

Table 1: Trends in Manufacturing Employment and Output, 1975-85

	Number of Workplaces*	Employment	Percent of Total Employment	Shipments (million yen)	Percent of Value-Added**	Shipment Volume Index (1981=100)
1975	430,491	10,660,000	25.5%	¥125,841,000	25.9%	74.5
1981	436,463	10,567,601	24.8	224,711,947	29.5	100.0
1982	427,998	10,480,985	24.5	229,934,044	30.3	99.3
1983	446,942	10,650,971	24.5	235,526,868	31.7	102.8
1984	428,998	10,733,413	24.9	253,029,814	33.7	111.8
1985	438,518	10,889,949	25.0	265,320,551	35.0	115.8

*Data refer to workplaces employing at least four people.

**Value-added in manufacturing as percent of gross domestic product.

Sources: Ministry of International Trade and Industry, Census of Manufactures: Report by Industries, 1985, for establishment, employment and shipment data; Managment and Coordination Agency, Labor Force Survey, for labor force data; Economic Planning Agency, Annual Report on National Accounts, for percent of value-added in manufacturing; and Ministry of International Trade and Industry, Industrial Statistics Monthly, for shipment index.

Table 1 also shows another striking result. While the number of manufacturing establishments was virtually unchanged between 1981 and 1985 and the number of workers increased by only 3.1 percent, shipments increased by 15.8 percent after adjusting for inflation, further evidence of the already well-known increase in Japan's manufacturing productivity. An almost constant proportion of the labor force was able to produce a rising percentage of the economy's total output as measured by value-added -- the difference between the costs of raw materials and intermediate inputs and sales at each stage of production. In a sense, Japan's experience has a parallel in the United States, where for years manufacturing has been relatively stable as a percentage of output but falling as a percentage of total employment.

Between 1981 and 1985 the relative importance of various kinds of manufacturing changed in Japan, as Table 2 shows. Generally, highly capital-intensive industries such as petroleum refining and steel declined in relative importance and sometimes in absolute terms. For example, employment in petroleum refining dropped more than 15 percent while output declined 19 percent in

current yen and 15 percent adjusted for price changes. On the other hand, electric machinery employment was up 24 percent and output expanded 31 percent in yen terms or 25 percent in real terms. The result: petroleum refining dropped from 7.1 percent of manufacturing as measured by shipments to 4.9 percent and electric machinery rose by four percentage points to 15.4 percent.

Table 2: Changes in Industry Composition, 1981-85*

	<u>1981</u>	<u>1982</u>	<u>1983</u>	<u>1984</u>	<u>1985</u>
Food Products	7.9%	8.1%	8.3%	8.0%	7.7%
Tobacco Products, Beverages and Feed	2.8	2.9	2.9	2.8	3.2
Textile Mill Products	3.6	3.6	3.4	3.2	3.0
Apparel and Made-up Textile Products	1.4	1.4	1.4	1.3	1.4
Lumber and Wood Products	1.2	1.9	1.8	1.6	1.5
Furniture and Fixtures	1.3	1.3	1.2	1.1	1.1
Pulp, Paper and Paper Products	3.0	3.0	3.0	2.9	2.8
Printing and Publishing	3.3	3.4	3.5	3.3	3.4
Chemicals and Related Products	8.0	8.0	8.2	8.0	7.7
Petroleum Refining	7.1	6.9	6.1	5.4	4.9
Plastic Products	2.6	2.7	2.8	3.0	3.0
Rubber Products	1.1	1.1	1.1	1.1	1.1
Leather and Leather Products	0.5	0.4	0.4	0.4	0.4
Nonmetallic Mineral Products	3.8	3.7	3.7	3.5	3.3
Steel	7.7	7.6	6.8	6.8	6.7
Nonferrous Metals	3.2	2.9	2.9	2.8	2.4
Fabricated Metal Products	4.9	4.9	4.8	4.7	5.0
Nonelectric Machinery	8.6	8.7	8.6	8.8	9.1
Electric Machinery	11.4	12.0	13.4	15.4	15.4
Transportation Equipment	12.5	12.5	12.6	12.7	13.6
Precision Instruments	1.7	1.6	1.6	1.6	1.7
Ordnance**	0.0	0.0	0.0	0.0	0.0
Other	1.5	1.5	1.5	1.5	1.5

*Based on value of shipments!

**Less than 0.1 percent each year.

Source: Ministry of International Trade and Industry, Census of Manufactures, 1985.

Table 3 combines the 21 industries of Table 2 into three categories developed by the Ministry of International Trade and Industry. A glance at the broad groupings of basic industries, processing and fabricating, and consumer-oriented and other industries shows that the first group rose between 1975 and 1979 and then contracted through 1985; the processing and fabricating category declined, then increased; while the third group declined slowly. Basic industries are especially energy-intensive and part of their relative decline in the 1980s may have been a reaction to the jump in oil prices in the late 1970s, although the decline continued into the mid-1980s in the face of falling real prices for petroleum.

Table 3: Trends by Industry Groups, 1975-85
(percent of total value-added in manufacturing)

	<u>Basic Industries</u>	<u>Processing and Fabricating Industries</u>	<u>Other Industries</u>
1975	39.6%	33.3%	27.0%
1976	39.3	34.4	26.4
1977	39.2	34.7	26.1
1978	40.2	33.5	26.3
1979	42.1	32.9	25.0
1980	41.3	34.4	24.2
1981	39.0	36.3	24.6
1982	38.3	37.0	24.7
1983	37.2	38.1	24.7
1984	37.1	39.4	23.5
1985	36.4	40.3	23.2

Note: Basic industries include lumber and wood products; pulp, paper and paper products; chemicals and related products; petroleum and coal products; plastic products; rubber products; nonmetallic mineral products; steel; nonferrous metals; and fabricated metal products.

Processing and fabricating industries include nonelectric machinery, electric machinery, transportation equipment and precision instruments.

Other industries include food products; tobacco products, beverages, and feed; textile mill products; apparel and made-up textile products; furniture and fixtures; printing and publishing; leather and leather products; and other manufacturing.

Source: Ministry of International Trade and Industry, Census of Manufactures: Report by Industries, 1985, pp. 18-19.

Evaluating Value-Added

Some experts believe that as the Japanese economy matures, manufacturers emphasize increasingly sophisticated products that involve more specialized labor skills and highlight the identities of the companies producing them, enabling producers to build more profit into their prices. In other words, they substitute high value-added production for low value-added output.

Gasoline is a typical low value-added product. Because one brand is perceived to be much like another, competition is fierce and markups low. One reason is that the production process is relatively simple and a refiner does little to transform the product. With high value-added products, on the other hand, a firm may spend millions of yen or dollars coming up with unique products it can sell at high prices, a process involving highly paid labor for the development effort. Aircraft are an example of such a product.

As already noted, low value-added products, including refined petroleum products, have declined in relative importance. The aircraft and parts industry increased some, remaining at 0.2 percent of all employment but rising from 1.6 percent to 1.9 percent of all shipments of manufactured goods. Other high value-added products did even better. Semiconductors, for example, soared from 2.3 percent of all shipments to 3.7 percent; between 1981 and 1985 more than 150,000 Japanese were added to the payrolls of semiconductor firms.

Are petroleum refining, aircraft and semiconductors indicative of a shift going on in the Japanese economy toward more value-added production? Table 4 provides data to consider this question.

Table 4: Value-Added by Industry, 1981 and 1985

	<u>Value-Added</u>		<u>Adjusted</u> <u>Value-Added</u>	
	<u>1981</u>	<u>1985</u>	<u>1981</u>	<u>1985</u>
Food Products	30.3%	31.8%	19.0%	20.3%
Tobacco Products, Beverages and Feed	23.6	22.9	17.9	17.5
Textile Mill Products	40.0	37.2	19.2	19.9
Apparel and Made-up Textile Products	45.3	46.6	21.9	22.6
Lumber and Wood Products	30.9	34.2	15.4	17.7
Furniture and Fixtures	41.5	42.4	22.0	22.4
Pulp, Paper and Paper Products	28.1	31.0	16.5	18.8
Printing and Publishing	53.6	51.0	31.0	28.4
Chemicals and Related Products	68.8	38.7	43.9	30.0
Petroleum Refining	8.6	8.3	4.4	6.8
Plastic Products	33.6	35.9	19.6	21.9
Rubber Products	38.1	39.8	21.3	21.9
Leather and Leather Products	35.3	37.1	18.6	20.2
Nonmetallic Mineral Products	42.6	44.9	27.0	28.2
Steel	27.8	29.2	18.0	19.1
Nonferrous Metals	24.4	24.5	15.7	14.5
Fabricated Metal Products	41.8	42.2	23.2	23.3
Nonelectric Machinery	41.2	41.3	23.5	23.5
Electric Machinery	37.5	36.4	22.7	23.0
Transportation Equipment	26.7	27.0	15.7	16.2
Precision Instruments	39.1	41.9	19.8	23.1
Ordnance	49.6	43.7	14.0	19.0
Other	41.1	41.7	23.5	25.0
Total	32.6	34.1	19.8	21.1

Source: Ministry of International Trade and Industry, Census of Manufactures, 1985.

The revenues from selling a product can go toward one of several purposes: to pay for materials, to pay for labor, to replace depreciating equipment, to pay taxes, to repay borrowed funds or toward profit. Higher value-added production implies that a larger proportion goes toward labor (because

the workers are highly skilled and therefore more expensive) or toward profit (because the company faces less competition).

One way of measuring value-added is to divide total shipments into the sum of labor costs, interest payments and profit. The higher this figure, the higher the value-added. This number is shown in the first and second columns of Table 4. The problem with this procedure is that industries that use a lot of labor, even if it receives very low wages, end up with a high figure. While few economists would regard apparel as a high value-added industry, it has one of the biggest numbers.

An alternative procedure is to leave out the payments to labor. This procedure approximates per-unit profitability and should give an indication of the extent to which a firm successfully differentiates its products, enabling it to earn higher profits. Of course, this measure excludes the possibility that the firm may be adding value by employing highly skilled and well-paid workers. This figure, termed adjusted value-added, is reported in the second set of columns in Table 4. The numbers support the argument that the Japanese economy is moving toward higher value-added production. For example, adjusted value-added in food products rose from 19 percent to 20.3 percent between 1981 and 1985.

Comparing Industries

Table 5 shows the relative size of Japanese industries. Nonelectric and electric machinery together account for more than a quarter of all manufacturing employment and an equal percentage of value-added. Wages range from a low of Y1,621,000 per year (\$6,811 at the average 1985 exchange rate of Y238=\$1.00) in the apparel industry to Y4,068,000 (\$17,092) in the transportation equipment industry. In motor vehicle production, which accounted for almost 80 percent of the employment in the latter industry, cash earnings averaged Y4,057,000 (\$17,046). In 1988, with the yen averaging around 125 to the dollar, these figures would obviously be much higher in dollar terms.

The table also highlights the tremendous number of workplaces; even on a more disaggregated basis and only counting workplaces with more than four employees, the figures are impressive. In the motor vehicle and automotive parts industries there were 10,777 such locations in 1985; sewing machines were made in 591 places. There were 9,500 people, more than four times the number in 1981, making robots at 422 locations. And 3,000 people labored making Western-style umbrellas, many times the mere 75 employed nationwide making Japanese-style ones.

Table 6 gives a more detailed view of one key industry -- steel. Like manufacturing generally, output per worker is increasing in every part of the industry. While manufacturing as a sector produced much more with a constant number of workers, steel output increased modestly using fewer workers. (In constant yen, output increased 6.7 percent.) In some parts of the industry employment declines were fairly dramatic even over the relatively brief 1981-85 period shown. While these losses were by and large easily absorbed because the firms in question had other jobs for the workers in question, the figures raise questions about how more widespread structural shifts would be handled.

Table 5: Comparing Industries, 1985
(workplaces with four or more employees)

	Number of Workplaces	Employees	Percent of All Workers	Average Annual Cash Earnings (thousand yen)	Percent of Value-Added
Food Products	46,296	1,016,731	9.3%	¥2,339	7.2%
Tobacco Products, Beverages and Feed	6,056	139,767	1.3	3,309	2.2
Textile Mill Products	35,424	609,462	5.6	2,307	3.3
Apparel and Made-up Textile Products	30,750	539,538	5.0	1,621	1.9
Lumber and Wood Products	22,762	276,444	2.5	2,404	1.5
Furniture and Fixtures	17,375	221,663	2.0	2,566	1.3
Pulp, Paper and Paper Products	11,899	275,495	2.5	3,279	2.5
Printing and Publishing	29,544	515,213	4.7	3,921	5.0
Chemicals and Related Products	5,352	395,748	3.6	4,529	8.8
Petroleum Refining	1,010	37,697	0.3	5,031	1.2
Plastic Products	18,135	382,247	3.5	2,940	3.2
Rubber Products	5,682	165,315	1.5	3,239	1.3
Leather and Leather Products	5,650	76,509	0.7	2,279	0.4
Nonmetallic Mineral Products	21,191	465,483	4.3	3,142	4.3
Steel	6,855	388,357	3.6	4,643	5.7
Nonferrous Metals	4,377	163,392	1.5	3,907	1.7
Fabricated Metal Products	50,311	786,604	7.2	3,126	6.1
Nonelectric Machinery*	43,879	1,126,614	10.3	3,834	11.1
Electric Machinery	34,196	1,825,314	16.8	3,007	16.4
Transportation Equipment	15,521	961,590	8.8	4,068	13.6
Precision Instruments	7,905	261,784	2.4	3,137	2.0
Other	18,348	258,982	2.4	2,600	1.9
Total	438,518	10,889,949	100.0	3,184	100.0

*Includes ordnance.

Source: Ministry of International Trade and Industry, Census of Manufactures: Report by Industries, 1985.

Table 6: Components of the Steel Industry, 1985

	<u>Percent of Steel Industry Employment</u>	<u>Average Annual Salary*</u>	<u>Four-Year Shipment Growth Rate</u>	<u>Four-Year Employment Growth Rate</u>
Steel Produced in Blast Furnaces	33.2%	¥5,541	-0.9%	-6.9%
Steel not Produced in Blast Furnaces	1.4	4,479	-23.2	-29.8
Processed Rolled Steel	13.5	5,148	8.4	-3.0
Unprocessed Rolled Steel	14.0	4,417	0.9	-13.7
Surface-treated Steel	1.4	4,576	6.6	-23.8
Forged and Cast Steel	7.4	4,052	-1.7	-15.8
Pig Iron Castings	14.5	3,802	6.2	-8.5
Other Steel	14.5	3,500	16.0	1.2
Total	100.0	4,643	3.1	-8.0

*In thousands of yen.

Source: Ministry of International Trade and Industry, Census of Manufactures, 1985.

Importance of Small-Scale Manufacturing

Just because there are a lot of workplaces does not mean there are a lot of firms involved in manufacturing; conceivably these facilities could be operated by a relatively small number of firms. That is not the case, however. There is also a very large number of companies in Japan that manufacture, a total of more than 87,000 counting only those that employ at least 20 people.

The first two columns of Table 7 show the relationship between the number of firms and the number of workplaces. (These figures are less inclusive than in previous tables, referring to firms having at least 20 employees. They accounted for 75.4 percent of the employment reported in Tables 1-5.) As firms become larger, they operate in more locations. Firms that employ more than 5,000 people, for example, operate in an average of 10.9 workplaces. The smallest firms operate in only one.

The table also shows that just over half of all Japanese manufacturing workers are employed by firms having fewer than 300 employees and that these people are paid less than those working for larger firms. Bigger companies also contribute more than their share of value-added, although firms employing fewer than 1,000 still account for half of the total.

There were only 91 manufacturing firms in 1985 employing more than 5,000 workers, a figure that had dropped from 112 in the 1975 census of manufactures. (The comparable figure for the United States in 1987 was over 400 companies.) While in 1975 the biggest firms employed 19.7 percent of all production workers, by 1985 the figure had fallen to 16.2 percent. The number employed by such firms declined by 18.3 percent between 1975 and 1985, while the number employed

by firms having between 20 and 30 employees increased 55.7 percent. For firms employing at least 20 people, average employment dropped from 112.8 per firm in 1975 to 94.4 in 1985.

Table 7: Employment Data by Firm, 1985

<u>Employment Level by Firm</u>	<u>Average Number of Workplaces</u>	<u>Percent of Employees</u>	<u>Cumulative Percent of Employees</u>	<u>Average Annual Cash Earnings (thousand yen)</u>	<u>Cumulative Gross Value-Added</u>
20-29	1.0	11.4%	11.4%	Y2,628	6.7%
30-49	1.0	8.9	20.3	2,745	12.1
50-99	1.1	13.8	34.1	2,763	21.0
100-199	1.4	13.1	47.2	2,923	30.4
200-299	1.7	6.9	54.1	3,084	35.7
300-499	2.0	7.4	61.5	3,452	42.8
500-999	2.5	8.4	69.9	3,680	52.2
1,000-4,999	4.4	14.0	83.9	4,307	72.5
Over 5,000	10.9	16.2	100.0	4,838	100.0
Total	1.2	100.0	100.0	3,469	100.0

Note: Percentage totals may not add to 100 due to rounding.

Source: Ministry of International Trade and Industry, Census of Manufactures, 1985.

Other Developments

Many companies operate in more than one industry. Japan's Fair Trade Commission has found that the trend is accelerating. As Table 8 shows, the percentage of output of each firm accounted for by its "home" industry has been declining. Experts believe that, if anything, the era of the high yen has speeded up this process. Steel firms, for example, have come to believe that foreign demand for their products will continue to be weak and are therefore seeking new opportunities. NKK Corp. (formerly Nippon Kokan K.K.) is developing new biotechnology products and Nippon Steel Corp. is selling U.S.-made super-minicomputers to Japanese customers. While diversifying companies have high hopes for these ventures, their ultimate success remains in doubt, in part because new management techniques are required to run diversified firms.

Complicating life still more for management is another trend now picking up speed: overseas investment. While Americans are most familiar with Japanese manufacturing investment here (see JEI Report No. 21A, May 27, 1988), it is a worldwide phenomenon. In the long-run offshore production could lead to a significant loss of employment opportunities in Japan, although the investment is still too limited to have had an impact. In early 1986 foreign affiliates of Japanese manufacturing companies employed about 800,000 workers. Estimates vary, but Japanese manufacturers are estimated to produce between 3 and 5 percent of their output abroad (see JEI Report No. 5A, February 5, 1988). The percentage of their foreign sales produced abroad may be much higher; Matsushita Electric Industrial Co., Ltd. says that it is approaching its goal of

manufacturing 50 percent of the products it sells overseas at offshore facilities.

Table 8: Share of Sales in Home Industry

(percent in each fiscal year)

<u>Home Industry</u>	<u>FY 1979</u>	<u>FY 1984</u>	<u>FY 1986</u>
Food Products	96.1%	96.8%	97.0%
Textiles	66.3	60.3	57.1
Wood and Wood Products	86.1	72.8	68.8
Pulp and Paper	86.1	93.0	92.5
Printing and Publishing	99.9	100.0	88.3
Chemicals	88.4	88.7	84.6
Coal and Petroleum Products	99.2	99.7	99.2
Rubber Products	90.0	89.6	88.5
Nonmetallic Mineral Products	75.6	76.4	71.4
Steel	85.8	81.8	78.6
Nonferrous Metals	89.1	67.7	60.8
Fabricated Metal Products	91.5	90.9	90.0
Nonelectric Machinery	75.9	77.9	73.1
Electric Machinery	93.3	95.3	83.6
Transportation Equipment	79.4	77.0	79.0
Precision Instruments	59.1	45.1	37.6
Other Manufacturing	71.0	69.7	67.4
Average	86.7	84.5	80.2

Source: Japan Fair Trade Commission

Japanese firms are even beginning to import some of the products produced overseas, although the amounts are still small. Together with sales by American, European and Asian companies, manufactured imports have surged, reaching close to 50 percent of all imports in recent months and averaging 44.1 percent in 1987. As a group, the share of Asian countries exceeded that of the United States for the first time last year, capturing 28.2 percent of the market against 26.8 percent. Excluding extraordinary imports of gold from the United States in 1986, Japan's purchases of manufactures from this country were up 18.1 percent in dollar terms in 1987, compared to increases of 61.1 percent for the Asian newly industrialized countries and 47.8 percent for the European Community. The increases come against a backdrop of much lower manufactured imports in Japan than in other industrialized countries -- a gap that even with the recent increases Japan has not yet closed (see JEI Report No. 14A, April 8, 1988).

For Japanese manufacturers, manufactured imports from unaffiliated firms could represent a threat to their heretofore secure domestic business. For Japanese workers in the manufacturing sector, imports could also be a problem -- if not in terms of unemployment, then by narrowing their chances to do the kind of work they prefer to do.

All of these recent trends point to a convergence between the organizational structures of American and Japanese firms, with the latter doing most of the changing. With some differences, diversification in Japan is following the American effort of the 1970s; large-scale U.S. investment abroad occurred even earlier. Growing manufactured imports are also moving the structure of Japan's manufacturing sector toward that of the United States.

The automotive industry is a case in point. The U.S. industry expanded its overseas production capacity in the 1950s and 1960, a period during which Americans at first bought few cars produced overseas. In order to compete with increasing imports from non-affiliated companies such as Volkswagen AG, U.S. companies eventually brought in more cars from their overseas plants.

Today Japanese automotive makers are increasing production in the United States and elsewhere. In Japan itself, the imported car market is still small but the pattern is analogous to the earlier U.S. experience: European and American companies are selling cars in competition with products from the overseas factories or partners of Japanese firms. For years Chrysler Corp. has used its Dodge and Plymouth dealers to sell the products of its Japanese supplier, Mitsubishi Motors Corp., in which it has an equity interest. MMC in turn has a share of the Korean auto maker, Hyundai Motor Co., and industry analysts expect its dealers to soon start selling Korean cars in Japan.

Outlook

The Japanese manufacturing sector, long considered the force behind the country's economic juggernaut, continues a process of change. While the data are a little ambiguous, Japanese firms have been moving toward higher value-added production for some time. How well the manufacturing sector adapts to externally imposed changes, such as a currency that has doubled in value against the dollar in three years, will have a lot to do with future success. Largely hidden from the American view, which concentrates on Japan's giant multinationals, are thousands of smaller firms that employ most of the people who work in manufacturing. Their numbers and importance are increasing. Differences in firm size, coupled with different activities and levels of capital investment, have created diversity in the manufacturing sector. As Japanese firms expand their activities across more product lines and national boundaries, diversity will increase further. Those hoping that Japanese manufacturers are settling into a comfortable middle age will be disappointed but for many, in Japan and abroad, there will be new opportunities.

For further information, contact Douglas Ostrom.

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The views expressed in this report are those of the author and do not necessarily reflect those of the Japan Economic Institute.

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J A P A N · E C O N O M I C · I N S T I T U T E

J E I

R E P O R T

A Two-Part Report: A and B

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MITI White Paper Stresses Stability, Policy Coordination

The Ministry of International Trade and Industry has prepared 40 White Papers on International Trade over the years. Each one reviews the previous year, highlighting problems and making recommendations. Past documents have alternated between descriptions of serious setbacks such as the two oil shocks of the 1970s and declarations of triumphs like the rapid growth in exports of the 1960s. The 1987 version is a hybrid, covering a period of crises averted and potentially serious problems overcome or postponed. The stock market crashed, protectionist sentiment in the United States and elsewhere continued and the yen soared to new heights. While each carried the potential for disaster, the Japanese economy somehow overcame each.

Japan's Services Deficit Rises

Japan's overall current account surplus is inching downward but one component is changing rapidly. The already large services deficit widened last year, reversing the 1981-86 pattern of declining deficits. The increase occurred despite much higher investment income attributable mostly to the continued recycling of Japan's current account surpluses into capital flows overseas. As in the past this income in 1987 consisted mainly of dividends and interest earned on securities and loans rather than profits from manufacturing plants, distribution operations and other forms of direct investment (Table 1).

Table 1: Japan's Trade Balance in Services

(in millions of dollars)

<u>Year</u>	<u>Investment Income</u>		<u>Other Services</u>	<u>Total</u>
	<u>Total</u>	<u>Direct</u>		
1978	\$900	\$376	\$-8,287	\$-7,387
1979	2,011	345	-11,483	-9,472
1980	854	809	-12,197	-11,343
1981	-763	816	-12,810	-13,573
1982	1,718	992	-11,566	-9,848
1983	3,082	1,354	-12,188	-9,106
1984	4,231	1,428	-11,978	-7,747
1985	6,840	1,711	-12,005	-5,165
1986	9,473	1,412	-14,405	-4,932
1987	16,670	2,004	-22,372	-5,702

Source: Bank of Japan

Credit or blame for the turnaround in 1987 belongs in part to the Japanese tourist, whose purchases of airline tickets get counted as part of the transportation account, with expenditures abroad for hotels, meals and gifts coming under the travel account. Passenger fare payments by Japanese jumped 54.2 percent and travel expenditures soared 48.9 percent in 1987, resulting in the large deficits in both transportation and travel shown in Table 2.

Table 2: Detail of Japan's Services Trade, 1987

(in millions of dollars)

	<u>Credits</u> <u>(Exports)</u>	<u>Debits</u> <u>(Imports)</u>	<u>Net</u> <u>Balance</u>
Transportation	\$12,954	\$19,060	\$-6,106
Travel	2,097	10,760	-8,663
Investment Income	49,245	32,575	16,670
Other Private Transactions	12,617	22,506	-9,889
Official Transactions	2,727	441	2,286
Total	79,640	85,342	-5,702

Source: Bank of Japan

In recent years services trade has attracted increasing attention from American policymakers. Most of their interest is focused on items that Japan includes in "other private transactions." Covered by this category are management fees, patent royalties, agent fees, advertising, film rentals and some insurance receipts and payments. Despite the attention, these transactions account for 26.4 percent of reported imports of services and just 10.5 percent of total Japanese payments for goods and services in 1987.

Of course, the low figure could reflect barriers that prevent trade in services from occurring. For example, if U.S. construction firms win business in Japan as a result of recent market-opening moves and provide design services out of their U.S. offices, it would be recorded in the "other" figure. In addition, there is reason to believe that both exports and imports of services in this category are underreported.

Services are one of the principal items on the agenda for the Uruguay Round of multilateral trade negotiations. Japan has expressed support for the U.S. position of liberalizing services trade within the General Agreement on Tariffs and Trade framework. In late May it submitted a proposal intended to lead to new rules concerning banking, insurance, tourism and information. The proposal would insure other signatories the same opportunities domestic firms have, a principle known as national treatment, and clarify the remaining rules. Liberalizing services trade has gotten a lukewarm reception from many developing countries, which initially resisted even putting this subject on the GATT agenda.

Douglas Ostrom

Science And Technology Agreement May Be Finalized At Toronto Summit

In addition to addressing macroeconomic policy and trade issues at the June 19-21 economic summit in Toronto, the United States and Japan may use this opportunity to formally conclude a revised agreement governing bilateral science and technology cooperation. Japanese Ambassador Nobuo Matsunaga stated recently that Tokyo and Washington have been considering holding a special signing ceremony for the accord during the meetings. Both parties agreed on the substance of the new five-year pact March 31 (see JEI Report No. 14B, April 8, 1988), but felt that an additional three months were needed to iron out minor drafting differences.

U.S. observers hope that this agreement will open the door to a reciprocal flow of science and technology. Washington was the primary mover behind the negotiations to revise the existing 1980 accord, which it regarded as so vague that it had enabled Japan to easily exploit American research and development work in leading-edge technologies and improve its competitive position in certain fields at the expense of American industry. Thus, the Reagan administration insisted on more specific guidelines governing bilateral science and technology cooperation. These include:

- the creation of a senior-level government group to discuss science and technology issues;
- the admission of U.S. researchers to projects jointly funded by the private sector and the government;

urged his colleagues to enact a new bill. But others are less sanguine. Finance Committee chairman Lloyd Bentsen (D, Tex.), for example, has estimated the chances for a new trade law this year as no better than 50-50.

It is clearly premature to state that the trade bill has been abandoned. Work on the legislation has continued for roughly three years. Tired of focusing on trade, lawmakers themselves have admitted that they have little incentive to recommence the entire process during the 101st Congress -- little incentive, that is, except for the presidential and congressional elections this November. Not everyone on Capitol Hill believes that holding up passage of a compromise bill because of the plant-closing provision will make good politics. But there are some who do. And on the Senate floor it could take only one amendment to stall the revised bill in its tracks.

Eileen M. Doherty

Notes

Kansai Bidders - On June 6 Kansai International Airport Co., Ltd. announced that 15 of 48 applicants would be allowed to submit detailed bids to design the terminal facilities for the new airport. Eleven of the 15 survivors are foreign. Four are American-Japanese joint ventures -- I.M. Pei & Partners with Kumagai Gumi Co., Ltd.; Ellerbe Beckett/Parsons/Shimizu Partners; Kassarbaum Inc. and Kajima Corp./Hellmuth/Obata; and Cesar Pelli and Associates with Takenaka Corp. A New York firm -- Bernard Tschumi Associates -- is also still in the running. So are six European groups: Design System & Architekten Gemeinschaft (Japan/West Germany); Foster Associates/Ohbayashi Corp. (Great Britain/Japan); Naco/Taller de Arquitectura (Netherlands/Spain); Jean Nouvel et Associes-Sarl (France); Renzo Piano Architecte (France); and Prof. Ungers-Airconsult of West Germany.

The 15 will now submit bids to implement the overall terminal design done by Aeroports de Paris; KIAC expects to pick a final winner by early December. The results of the initial competition are a good start for the recently signed U.S.-Japan accord opening the Japanese public works market to foreign firms (see JEI Report No. 22B, June 10, 1988). The fact that more European applicants survived the first cut than American hopefuls could indicate that an evenhanded approach toward all foreign firms is being taken, allaying European fears of discriminatory treatment.

Primary Dealer Purchases - The Federal Reserve Board gave its consent June 6 to the purchase of primary dealers in U.S. government securities by the Long-Term Credit Bank of Japan, Ltd. and Sanwa Bank, Ltd. Greenwich Capital Markets Inc. will cost the Long-Term Credit Bank \$144 million, while the price Sanwa will pay for Brophy, Gestal, Knight & Co. is set at \$70 million.

The two applications had been pending for several months, long enough for Japanese bankers to begin to suspect that the Fed was trying to prevent them from establishing a bigger presence in the U.S. Treasury securities market. In its accompanying statement, the Federal Reserve did little to allay this fear, hinting that it would have had no problem accepting a provision in

the omnibus trade bill barring foreign companies from buying primary dealers unless there was reciprocal U.S. access to foreign government debt markets. Since the legislation was vetoed by President Reagan, however, the Fed felt it could delay no longer.

In addition to gaining a coveted primary dealership, LTCB will also get Greenwich Capital Markets' seats on the Chicago Mercantile Exchange and the Chicago Board of Trade. Of the Japanese financial firms active in the U.S. market, only Nikko Securities Co., Ltd. has a seat on the CBOT. Nomura Securities International Inc., Nikko Securities Co. International Inc., Daiwa Securities America Inc. and the Industrial Bank of Japan, Ltd. also own primary government securities dealers, while Fuji Bank, Ltd. recently agreed to acquire a 24.9 percent interest in another of the 42 current dealers.

Agricultural Export Embargoes - The House Foreign Affairs international economic policy and trade subcommittee met June 8 to consider HR 4692, a bill to prohibit embargoes of U.S. agricultural exports except to countries that are engaged in war or military hostilities against the United States. The bill's sponsor, Rep. Bill Alexander (D, Ark.), argued that agricultural sanctions end up harming this country's interests more than those of any other nation. In any case, he said, the United States needs the trade, especially in light of its huge trade deficit. According to the congressman, that U.S. farmers suffer from the sanctions is made all the more frustrating by the fact that agricultural embargoes do not work, especially when U.S. allies do not implement similar sanctions. Mr. Alexander argued that Japan and Western European countries actually benefit from U.S. sanctions on shipments to Cuba and Central America. In fact, however, Japan exports virtually no agricultural products.

The Reagan administration opposes the legislation on the grounds it would limit presidential flexibility in formulating foreign policy. Officials point out that the White House already operates under severe constraints regarding agricultural embargoes. Moreover, Assistant Secretary of State for Economic and Business Affairs Eugene McAllister has indicated that the administration will suggest during the Uruguay Round of multilateral trade negotiations that signatories to the General Agreement on Tariffs and Trade should no longer be permitted to restrict sales of agricultural goods in short-supply situations.

Multilateral Investment Guarantee Agency - Yoshio Terasawa, an executive with Nomura Securities Co., Ltd., has been chosen as president of the Multilateral Investment Guarantee Agency. MIGA was established by members of the World Bank and Switzerland to issue guarantees against non-commercial risks to participants that invest in a member developing country (see JEI Report No. 22B, June 12, 1987). Mr. Terasawa's appointment will be formally made June 22 at the first meeting of MIGA. Tokyo, an enthusiastic supporter of the organization, was the first developed country to ratify the convention establishing MIGA.

Japan's FY 1987 Foreign Direct Investment - The multinationalization of Japanese businesses continued at a record-breaking rate in the April 1987-March

1988 period, with companies earmarking \$33.4 billion for foreign direct investment on top of a planned expansion of \$22.3 billion in FY 1986 and a \$12.2 billion projected increase the previous fiscal year. For many firms internationalization has meant establishing a presence in the American market or expanding an existing U.S. operation. That was certainly true in FY 1987. Businesses once again put roughly 45 percent of the money set aside for offshore equity investment into the United States -- a ratio that translated into \$14.7 billion compared with \$10.2 billion in the 12 months through March 1987. But there were differences in how the rest of the pool of direct investment funds was divided up geographically. Bigger portions went into Europe (\$6.6 billion versus \$3.5 billion) and Asia (\$4.9 billion, up from \$2.3 billion), while investment in Latin America barely topped FY 1986's total at \$4.8 billion (see Table 1).

Contrary to the conventional wisdom, financial institutions, not manufacturers, are the leaders of the offshore investment movement. They have accounted for close to one-third of all foreign direct investment in each of the last three fiscal years, channeling \$10.7 billion into overseas banking, finance and insurance operations in FY 1987 alone -- nearly 50 percent more than in FY 1986 (see Table 2). The conventional wisdom is not completely off base, however, since Japanese manufacturers more than doubled the amount of money going into offshore production facilities during the April 1987-March 1988 period to \$7.8 billion.

While foreign investment in the financial services sector was split fairly evenly among Latin America, Europe and the United States in FY 1986, Europe was the main draw in FY 1987. It attracted \$4.5 billion in new capital compared with a \$2.9 billion inflow to this country and a \$2.6 billion increase in Latin America. For manufacturers, however, the United States remained the prime location. They invested another \$4.9 billion here in the year through March 1988 or almost three times more than the \$1.7 billion that went into Asia. Similarly, \$4.4 billion of the \$5.4 billion invested in foreign real estate ventures went into the United States.

The \$33.4 billion jump in direct overseas investment in FY 1987 boosted the cumulative total to \$139.3 billion (see Table 3). While there is no question that Japanese companies are rapidly expanding their international investment presence, this figure is thought to overstate the size of their equity holdings abroad since it is based on investment plans reported to the Ministry of Finance, not actual flows. A more realistic number, derived from the balance of payments data, was \$77.6 billion at the end of 1987 (see JEI Report No. 22B, June 10, 1988).

* * * * *

The views expressed in this report are those of the authors and do not necessarily represent those of the Japan Economic Institute.

Table 1: Japan's Foreign Direct Investment by Country, FY 1983-FY 1987

(in millions of dollars)

	FY 1983	FY 1984	FY 1985	FY 1986	FY 1987	Cumulative March 31, 1988
United States	\$2,565	\$3,360	\$5,395	\$10,165	\$14,704	\$50,159
Canada	136	184	100	276	653	2,604
North America	2,701	3,544	5,495	10,441	15,357	52,763
Indonesia	374	374	408	250	545	9,218
Hong Kong	563	412	131	502	1,072	4,505
Singapore	322	225	339	302	494	3,065
Korea	129	107	134	436	647	2,765
China	---	114	100	226	1,226	1,740
Malaysia	140	142	79	158	163	1,446
Taiwan	103	65	114	291	367	1,419
Thailand	72	119	48	124	250	1,134
Philippines	65	46	61	21	72	985
Asia	1,847	1,628	1,435	2,327	4,868	26,658
Panama	1,223	1,671	1,533	2,401	2,305	11,146
Brazil	410	318	314	270	229	5,086
Cayman	1	1	132	930	1,197	2,476
Bahama	1	97	298	792	734	1,981
Mexico	121	56	101	226	28	1,584
Peru	---	6	10	---	1	696
Bermuda	14	29	148	16	36	653
Netherlands Antilles	69	66	62	66	199	575
Latin America	1,878	2,290	2,616	4,737	4,816	25,189
United Kingdom	153	318	375	984	2,473	6,598
Luxembourg	265	315	300	1,092	1,764	4,072
Netherlands	113	452	613	651	829	3,166
West Germany	117	245	172	210	403	1,955
France	93	117	67	152	330	1,300
Switzerland	37	229	60	91	224	977
Spain	52	140	91	86	283	883
Belgium	126	71	84	50	70	863
Europe	990	1,937	1,930	3,469	6,576	21,047
Australia	166	105	468	881	1,222	5,724
Oceania	191	157	525	992	1,413	6,647
Liberia	323	281	159	289	267	3,010
Africa	364	326	172	309	272	3,951
Kuwait	66	55	34	41	54	1,363
Iran	1	0	0	---	---	1,003
Middle East	175	273	45	44	62	3,079
Total	8,145	10,155	12,217	22,320	33,364	139,334

Source: Ministry of Finance

Table 2: Japan's Foreign Direct Investment by Sector, FY 1983-FY 1987

(in millions of dollars)

	<u>FY</u> <u>1983</u>	<u>FY</u> <u>1984</u>	<u>FY</u> <u>1985</u>	<u>FY</u> <u>1986</u>	<u>FY</u> <u>1987</u>	<u>Cumulative</u> <u>March 31,</u> <u>1988</u>
Manufacturing Sector	\$2,588	\$2,505	\$2,352	\$3,806	\$7,832	\$36,038
Food Products	77	118	90	127	328	1,546
Textiles	174	85	28	63	206	2,353
Wood and Paper Products	91	115	15	57	317	1,495
Chemicals	450	223	133	355	910	5,247
Metals	479	718	385	328	786	6,304
Nonelectric Machinery	169	185	352	626	687	3,284
Electric Machinery	502	409	513	987	2,421	7,155
Transport Equipment	486	437	627	828	1,473	5,675
Other	160	215	208	435	703	2,980
Nonmanufacturing Sector	5,357	7,429	9,536	17,949	25,080	99,365
Agriculture and Forestry	18	26	12	15	97	893
Fisheries	17	24	42	52	44	538
Mining	382	484	598	669	511	12,936
Construction	55	112	94	250	87	1,134
Trade and Sales	1,164	1,482	1,550	1,861	2,269	16,807
Banking, Finance and Insurance	1,167	2,085	3,805	7,240	10,673	28,772
Services	622	681	665	1,560	2,780	9,026
Transportation	1,363	1,651	1,240	1,925	2,145	9,970
Real Estate	375	430	1,207	3,997	5,428	11,958
Other	193	454	322	379	1,047	7,332
Branch Offices	200	221	329	566	452	3,336
Real Estate Transactions*	---	---	---	---	---	595
Total	8,145	10,155	12,217	22,320	33,364	139,334

*Overseas real estate transactions have been excluded from Japan's foreign direct investment data since December 1, 1980 because of changes in the Foreign Exchange and Foreign Trade Control Law.

Source: Ministry of Finance

Table 3: Japan's Foreign Direct Investment by Industry and Region, March 31, 1988

	(in millions of dollars)							
	North America	Latin America	Asia	Middle East	Europe	Africa	Oceania	Total
Manufacturing Sector	\$14,753	\$4,994	\$10,000	\$1,260	\$3,310	\$225	\$1,496	\$36,038
Food Products	724	207	425	0	112	8	68	1,546
Textiles	397	428	1,231	4	245	39	9	2,353
Wood and Paper Products	952	200	212	-	2	0	128	1,495
Chemicals	1,499	562	1,585	1,124	347	19	111	5,247
Metals	1,650	1,764	2,064	59	276	127	364	6,304
Nonelectric Machinery	1,716	361	778	11	365	1	53	3,284
Electric Machinery	4,451	366	1,562	13	704	7	53	7,155
Transport Equipment	2,221	995	1,028	4	797	17	613	5,675
Other	1,142	112	1,115	45	462	7	98	2,980
Nonmanufacturing Sector	36,858	20,126	16,286	448	16,794	3,722	5,131	99,365
Agriculture and Forestry	260	186	262	2	5	7	171	893
Fisheries	139	104	129	1	3	92	69	538
Mining	1,440	1,549	6,677	199	890	579	1,601	12,936
Construction	510	203	254	40	57	21	49	1,134
Trade and Sales	9,727	1,397	1,482	19	3,374	7	801	16,807
Banking, Finance and Insurance	9,149	6,913	1,447	93	10,508	22	640	28,772
Services	3,164	826	3,173	4	540	664	655	9,026
Transportation	188	7,690	393	2	93	1,532	73	9,970
Real Estate	10,130	55	846	-	268	-	658	11,958
Other	2,151	1,203	1,622	87	1,056	798	415	7,332
Branch Offices	667	45	336	1,369	905	1	12	3,336
Real Estate Transactions*	485	23	37	2	38	2	7	595
Total	52,763	25,189	26,658	3,079	21,047	3,951	6,647	139,334

*Overseas real estate transactions have been excluded from Japan's foreign direct investment data since December 1, 1980.

Source: Ministry of Finance

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J A P A N · E C O N O M I C · I N S T I T U T E

JEI

R E P O R T

A Two-Part Report: A and B

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Japan's Economy In High Gear

Prime Minister Noboru Takeshita had unusually good news to share with his counterparts from the other leading industrialized nations at the Toronto summit. Japan's gross national product in the first three months of 1988 rose at a real annual rate of 11.3 percent, the fastest pace in 11 years. The seasonally adjusted quarter-to-quarter gain of 2.7 percent almost equalled the U.S. growth rate of 2.9 percent for all of 1987.

The latest quarter was the third straight period of strong growth (see Table 1), but the components have been changing. While the second half of last

Table 1: Japan's Real Gross National Product at Constant (1980) Prices

(in billions of yen, seasonally adjusted, quarterly totals and rates of growth at annual rates)

	FY 1986	FY 1987	April- June 1987	July- September 1987	October- December 1987	January- March 1988
Gross National Product	Y301,679.7 (2.6%)	Y316,610.9 (4.9%)	Y306,805.8 (0.0%)	Y313,030.0 (8.4%)	Y318,776.3 (7.5%)	Y327,402.3 (11.3%)
Personal Consumption Spending	169,195.1 (3.6%)	175,927.4 (4.0%)	173,089.9 (2.7%)	174,877.5 (4.2%)	175,663.0 (1.8%)	180,233.0 (10.8%)
Private Residential Construction	15,637.9 (10.9%)	19,368.0 (23.9%)	16,950.2 (12.5%)	18,679.1 (47.5%)	21,042.6 (61.1%)	21,250.9 (4.0%)
Private Fixed Nonresidential Investment	56,361.2 (4.5%)	62,079.0 (10.1%)	58,973.3 (7.3%)	60,554.5 (11.2%)	63,065.7 (17.6%)	65,336.6 (15.2%)
Change in Business Inventories	515.2 (*)	966.0 (*)	906.7 (*)	716.3 (*)	1,172.2 (*)	1,050.6 (*)
Government Current Expenditures	29,002.0 (6.8%)	28,779.3 (-0.8%)	28,726.6 (4.9%)	28,648.5 (-1.1%)	28,706.9 (0.8%)	29,028.8 (4.6%)
Government Fixed Investment	22,162.2 (6.6%)	24,558.9 (10.8%)	22,797.4 (6.9%)	23,496.0 (12.8%)	25,046.4 (29.1%)	26,045.3 (16.9%)
Change in Government Inventories	816.0 (*)	41.5 (*)	-1,891.6 (*)	-9.2 (*)	-163.3 (*)	452.3 (*)
Net External Sector	7,990.1 (-35.0%)	4,890.8 (-38.8%)	5,463.9 (-87.9%)	6,067.3 (52.0%)	4,242.8 (-76.1%)	4,004.8 (-20.6%)
Exports of Goods and Services and Factor Income Received	52,689.5 (-3.6%)	55,303.6 (5.0%)	52,466.1 (-7.2%)	55,981.6 (29.6%)	55,472.2 (-3.6%)	57,419.7 (14.8%)
Imports of Goods and Services and Factor Income Paid	44,699.5 (5.5%)	50,412.8 (12.8%)	47,002.2 (28.0%)	49,914.3 (27.2%)	51,229.4 (11.0%)	53,414.9 (18.2%)

*Cannot be calculated or meaningless.

Source: Economic Planning Agency

year saw an unusually strong contribution from housing, in the latest quarter it was relatively flat, contributing a mere 0.1 percentage point to the overall 2.7 percent quarterly growth rate. This compares with a 0.8 point contribution in the October-December period. In contrast, consumer spending, the previously sluggish giant, surged forward at a 10.8 percent annual clip and contributed 1.4 percentage points. Still, its share in the total economy slipped for the third straight quarter.

The real star this time around was corporate spending, up 15.2 percent on an annual basis and contributing 0.7 percentage point to overall growth. Reflecting the continuing effects of last year's fiscal stimulus package, government spending (current expenditures, fixed investment and inventories) also rose sharply, contributing 0.6 percentage point to the rise in GNP.

In what has become a widely publicized pattern, the external sector remained stuck in reverse, pulling down the growth rate as imports expanded faster than exports. The adverse effect on the overall quarterly growth rate, however, was a mere 0.1 percentage point.

For the second straight year, the external sector was a significant drag on the economy in FY 1987 which ended in March. Overall inflation-adjusted growth was 4.9 percent, easily surpassing the government's December outlook of 3.7 percent, but the external sector knocked 1 point off the growth rate in marked contrast to the 6 point contribution of domestic growth (see Table 2).

Table 2: Components of Japan's Real Economic Growth

	<u>Total Rate</u>	<u>Domestic Component</u>	<u>External Component</u>	<u>Current Account Surplus*</u>
FY 1970	8.3%	8.9%	-0.7%	\$2.3
FY 1971	5.3	4.0	1.3	6.3
FY 1972	9.7	10.6	-0.8	6.2
FY 1973	5.3	7.5	-2.2	-3.9
FY 1974	-0.2	-2.8	2.6	-2.3
FY 1975	3.6	2.0	1.6	0.1
FY 1976	5.1	3.6	1.5	4.7
FY 1977	5.3	4.2	1.0	14.0
FY 1978	5.1	6.9	-1.8	11.9
FY 1979	5.3	4.8	0.5	-13.9
FY 1980	4.0	1.0	3.0	-7.0
FY 1981	3.3	2.1	1.2	5.9
FY 1982	3.2	2.7	0.5	9.1
FY 1983	3.7	2.1	1.5	24.2
FY 1984	5.1	3.9	1.3	37.0
FY 1985	4.4	3.7	0.8	55.0
FY 1986	2.6	4.1	-1.5	94.1
FY 1987**	4.9	6.0	-1.0	84.5

*In billions of dollars.

**Preliminary.

Source: Economic Planning Agency

Fiscal years 1986 and 1987 were the first back-to-back years since the early 1970s to combine strong domestic growth with weak net exports. Although external demand is declining rapidly as a percentage of the economy, the current account surplus remains high, especially when measured in dollars.

Despite the rapid rate of growth in the January-March period, the Economic Planning Agency and the Bank of Japan are not very worried about the economy overheating and inflation rearing its head, partly because EPA estimates that growth in the current quarter has slowed dramatically. If there is a sharp downturn, some analysts expect the government to sweeten its tax reform proposals with larger income tax cuts than currently considered (see following article).

Douglas Ostrom

Stimulative Tax Reform Package Revealed

On June 15 the Liberal Democratic Party's Tax System Research Council unveiled the results of months of negotiations: a sweeping tax reform package that would lower corporate and individual income tax rates at the national level and institute a general consumption tax. The package would also cut inheritance taxes, increase credits for dependents and senior citizens, lower securities transactions taxes, and reduce or eliminate current commodity taxes; local income taxes would be trimmed as well. The LDP and the cabinet approved the package June 16. A 120-day extraordinary Diet session will be convened July 11 to consider the reforms. Most opposition parties welcome the tax reductions but remain adamantly opposed to any major indirect tax. The Democratic Socialist Party, however, has proposed some compromises that might win its support for the overhaul.

The package envisions tax reductions of Y5.6 trillion (\$44.8 billion at Y125=\$1.00) in FY 1990, composed of changes in:

- National personal income taxes - Reducing the number of brackets April 1, 1989 from 12 to five with a top rate of 50 percent for incomes above Y20 million (\$160,000) compared with the current maximum of 60 percent for incomes over Y50 million (\$400,000). Taxpayers at the low end will also benefit (see Table 1): the bottom rate will drop to 10 percent from 10.5 percent and will apply to incomes of less than Y3 million (\$24,000) instead of Y1.5 million (\$12,000). Credits for dependents, senior citizens and handicapped people also will be increased.

- Local personal income (residence) taxes - Reducing the number of brackets and cutting the maximum rate, also effective at the start of FY 1989. Combined with the cuts at the national level, these changes will total an estimated Y3.1 trillion (\$24.8 billion).

- Corporate income taxes - Cutting the maximum corporate rate in two steps until it reaches 37.5 percent in FY 1990, compared with the present 42 percent maximum. The rate for small- and medium-sized businesses will drop from 30 percent to 28 percent (see Table 2). The LDP council projects that these changes will cost Y1.8 trillion (\$14.4 billion) in revenue.

Table 1: Impact of Tax Reform on an Average Household*

(combined national and local income taxes in thousands of yen and percent)

<u>Annual Income</u>	<u>Current Tax</u>	<u>Tax Reduction</u>	<u>Percent Reduction</u>
Y3,000	Y48	Y39	81.3%
5,000	316	85	27.0
8,000	1,040	217	20.9
10,000	1,686	289	17.2
15,000	4,053	338	8.3
20,000	6,879	551	8.0

*For tax year 1990. Based on a salaried, four-person household with one child in the 16 to 22 age group.

Source: Nihon Keizai Shimbun

Table 2: Proposed Corporate Income Taxes

(in percent)

<u>Category</u>	<u>FY 1988</u>	<u>FY 1989</u>	<u>FY 1990</u>
Regular Corporations			
Retained earnings	42%	40%	37.5%
Dividends	32	35	37.5
Small Businesses			
Retained earnings	30	29	28
Dividends	24	26	28
Special Reduced Rates*			
Retained earnings	27	27	27
Dividends	22	25	27

*For cooperative associations and other special organizations.

Source: Ministry of Finance

• Inheritance and gift taxes - Reducing the top tax rates and increasing minimum taxable amounts. Partly in response to the sharp increase in land prices over the past few years, the Tax System Research Council recommended the first significant changes in inheritance and gift taxes in 13 years. Retroactive to April 1, 1988, the top rate will be reduced to 70 percent from 75 percent on estates above Y500 million (\$4 million) and gifts above Y70 million (\$560,000). The minimum taxable estate and individual inheritance will double to Y40 million (\$320,000) and Y8 million (\$64,000), respectively. The tax-exempt minimum for surviving spouses will also be doubled. These changes are expected to reduce revenues by Y700 billion (\$5.6 billion).

In exchange for these reductions, the government hopes to raise by FY 1990 a net Y3.2 trillion (\$25.6 billion) in revenues through the following changes:

• Capital gains tax - Calculating the tax liability (at the taxpayer's discretion) by one of the following methods: 20 percent of the yield, or 1 percent of the total value of the transactions. The impact of this will be softened by lowering the securities transactions tax from 0.55 percent to 0.3 percent of the transaction value for stocks and from 0.26 percent to 0.16 percent for bonds. Combined with small changes in other personal taxes (such as tougher regulation of inheritance taxes), this should bring in an estimated Y600 billion (\$4.8 billion).

• Corporate taxes - Keeping a closer watch on corporate tax returns and eliminating some tax exemptions by FY 1990, the tax office hopes to gain Y600 billion (\$4.8 billion).

• General consumption tax - Adding a 3 percent tax on goods and services will raise an estimated Y5.4 trillion (\$43.2 billion). Firms with annual sales of less than Y30 million (\$240,000) will be exempt and those with sales under Y60 million (\$480,000) will pay a reduced rate. The following transactions will be exempt: food, medical fees paid by public insurance, tuition fees, public works projects, real estate transactions, transfers of securities, insurance, loans, exports and international postal transfers (e.g., money orders or wired funds). Items that will retain their own specific commodity taxes (such as alcoholic beverages) will also be exempt. Most commodity taxes, however, will be abolished, reducing revenues by an estimated Y3.4 trillion (\$27.2 billion). A potentially important change for non-Japanese automakers is the decision to drop the 23 percent excise tax on full-size cars and cut the tax on compact and minicars from 18.5 percent to 6 percent. A general consumption tax won over a value-added tax such as that commonly used in European countries because of the greatly reduced paperwork (see Table 3). The changes in indirect taxes will yield a net Y2 trillion (\$16 billion) in revenue.

Table 3: An Example of the Proposed 3 Percent Indirect Tax

	(in yen)				
<u>Stage:</u>	<u>Raw/Basic Materials</u>	<u>Manu- facturing</u>	<u>Distri- bution</u>	<u>Retail</u>	<u>Consumer</u>
Purchase Price:		Y20,600	Y51,500	Y72,100	Y103,000
Of which tax:		Y600	1,500	2,100	3,000
Margin:		30,000	20,000	30,000	
Total Taxable Amount:	Y20,000	50,000	70,000	100,000	
Tax:	Y600	1,500	2,100	3,000	
Sale Price:	20,600	51,500	72,100	103,000	
Net Tax:	Y600	900	600	900	3,000

Source: Nihon Keizai Shimbun

• Alcoholic beverage taxes - Dropping the grading system for sake and wine, easing the grading system for whiskey and sharply reducing the levy based on alcoholic content (see Table 4). The tax on shochu, a popular local drink, will be raised by 75 percent to reduce the gap between levies on domestic and imported spirits. The expected impact is unclear, although the changes may be revenue-neutral.

Table 4: Proposed Alcoholic Beverage Taxes

(in yen per kiloliter)

<u>Product</u>	<u>Alcohol Content</u>	<u>Current Tax</u>	<u>Proposed Tax</u>
Sake			
Special	15%	Y570,600	Y133,700
Grade 1	15	279,500	133,700
Grade 2	15	107,900	133,700
Blended Sake	15	81,600	65,700
Shochu			
Grade A	25	78,600	119,800
Grade B	25	50,900	70,800
Mirin			
Regular	13.5	74,100	21,600
Fortified	22	63,500	34,400*
Beer	--	Y239,100	208,400
Wine			
Regular	--	159,800	46,300
Above grade	--	60,400	46,300
Below grade	--	49,700	46,300
Sweetened Wine	12	117,300	85,000
Whiskey			
Special	43	2,098,100	1,055,980*
Grade 1	40	1,011,400	982,300
Grade 2	37	296,200	908,620
Other Spirits	37	361,800	331,400
Liqueur			
Regular	15	367,000	106,270*
Other	12	117,300	85,000
Miscellaneous			
Distilled	--	239,100	208,400
Mirin-type	13.5	74,100	21,600
Other	12	117,300	85,000

*Base rate; total tax will depend on actual alcohol content.

Source: Ministry of Finance

In sum, the tax reform package will be stimulative, with total tax reductions outweighing increases by Y2.4 trillion (\$19.2 billion). This is equivalent to 4.2 percent of the fiscal 1988 general account budget of Y56.7 trillion (\$453.6 billion). Since this year's budget is already 4.8 percent bigger

than FY 1987's, the proposed tax cut will insure that the public sector plays a positive role in Japan's overall economic growth at least through the end of the decade.

Prime Minister Noboru Takeshita still faces major obstacles to winning Diet approval for the tax package despite the LDP's majority. Since his predecessor came close to political disaster over tax reform, Mr. Takeshita has been carefully preparing the public for his tax package. There is now a general sense of inevitability about the need for a new indirect tax, and the prime minister is hoping that the personal and business tax cuts will make the 3 percent general consumption tax more palatable.

Opposition parties will surely try to scuttle the tax increases in the package, but Mr. Takeshita's efforts to split the opposition appear to be having some success. The Democratic Socialists are showing signs of a willingness to compromise. With the support of one opposition party, the LDP can claim that it did not ram tax reform through the Diet. A lot of wheeling and dealing can be expected between now and mid-November when the extraordinary Diet session is scheduled to end.

Jon Choy

Japan Tops Ranks Of Borrowers, Too

At first it seems contradictory. Japan is the world's biggest creditor and the United States the largest debtor, yet recently released International Monetary Fund statistics appear to put Japan first as a net borrower in 1987, with the United States the runner-up even in this apparently dubious competition. Japan's second straight first-place finish comes after years during which the United States routinely took top honors (see Table 1).

Table 1: Net Cross-Border Flow of Bank Borrowing

(in billions of dollars)

	<u>1984</u>	<u>1985</u>	<u>1986</u>	<u>1987</u>
Japan	\$8	\$-2	\$40	\$76
United States	29	32	11	51
Other Industrialized Countries	-26	-25	-69	-60
Developing Countries (excl. offshore centers)	-8	-17	--	-19
Other Transactions	-7	-22	-49	10

Source: International Monetary Fund

Of course the data do not suggest that Japan and the United States are the world's leading basket cases. Nor do they undermine Japan's status as the largest creditor. In 1987 Japan incurred the most debt to banks overseas but also had the largest net outflow when all international financial flows are considered.

Table 2 gives some details. In addition to net export earnings as reflected in the balance of payments, Japanese firms borrowed from banks abroad. Together, these funds became a source of bank lending to nonbanks overseas, outflows from nonbanks in Japan to nonbanks elsewhere, and increases in official Japanese reserves. In ordinary language, the flows among nonbanks represent Japanese purchases of real assets and securities abroad. Borrowing overseas permitted these purchases to be larger than dictated by balance of payments considerations alone. In short, the figures show Japan's emergence as a global banking center -- with institutions located in Japan pooling funds from around the world to finance other international activities. Japan is a natural for this role, given its position as the largest creditor.

Douglas Ostrom

Table 2: Changes in Japan's International Financial Situation, 1987

(in billions of dollars)

Current Account Surplus	\$87
Plus: Net borrowing from overseas banks	76
Less: Net Japanese bank lending to nonbanks abroad	26
Less: Net financial outflows among nonbanks*	94
Equals: Change in official reserves	43

*Includes errors and omissions

Source: International Monetary Fund

Tokyo Shines At Toronto Summit

The annual summit meeting of the major industrial nations are important for building allied cooperation on economic and diplomatic issues but rarely result in major policy changes. This summit, held June 19-21, in Toronto, was no exception. The majority of the political declaration focused on East-West issues, such as Soviet reforms that have opened up commerce with the communist bloc and Moscow's more flexible approach to arms control. Antiterrorism commitments made during the last five summits were reaffirmed. The declaration also established a ministerial-level task force to explore more effective ways of cracking down on the international narcotics trade.

History may show, however, that new ground was broken in terms of Japan's role in this forum. Unlike previous summits where Tokyo found itself on the defensive due to trade frictions with other participants and its burgeoning trade surplus, Japan was able to take advantage of this occasion to demonstrate to its "peers" that it recognizes its global economic stature and has begun to embrace the responsibilities attendant with this leadership role. Prime Minister Noboru Takeshita was afforded a rare opportunity to pursue a more activist strategy in promoting Japan's proposals on a variety of issues, particularly Third World debt.

Mr. Takeshita went to Toronto with an impressive array of statistics substantiating the effectiveness of Japanese government policies designed to

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THE NEED FOR INTERNATIONAL COORDINATION OF MACROECONOMIC POLICY:
A STUDY BY MICHAEL M. HUTCHISON OF THE UNIVERSITY OF CALIFORNIA

Summary

For the last two years macroeconomic policy coordination has been near the top of the agenda for almost every meeting of the leaders of the world's major industrial democracies. In the following article, Michael M. Hutchison, assistant professor of economics at the University of California at Santa Cruz, evaluates the benefits and costs of this course of action. His paper was originally presented at a mid-March conference in San Francisco cosponsored by the Japan Economic Institute, the Japan Society of Northern California and the World Affairs Council of Northern California. A companion article will be published in the July 8 issue of JEI Report.

Introduction

Both in policy circles and among academics, discussions of international macroeconomic policy coordination have expanded in recent years. Interest in policy coordination in turn is associated with disillusionment with the present "non-system" of flexible exchange rates, in particular the wide swings in exchange rates and burgeoning trade and financial imbalances in the world economy (see Table 1) -- especially between the world's two major industrial nations, Japan and the United States.

Serious consideration of economic policy coordination, at least on the part of the United States, coincided with the peak of the dollar exchange rate in early 1985 and was expressed in the communique issued by the finance ministers from the Group of Five major industrial nations meeting at New York's Plaza Hotel in September 1985. Since then statements of G-5 and the Group of Seven

Table 1: Alternative Measures of Current Account Balances

	<u>1980</u>	<u>1985</u>	<u>1986</u>	<u>1987</u>	<u>1988*</u>
United States					
Billions of dollars	\$1.9	\$-116.4	\$-141.4	\$-160.7	\$-141.1
Percent of GNP	0.1%	-2.9%	-3.3%	-3.6%	-3.0%
Japan					
Billions of dollars	\$-10.7	\$49.2	\$85.8	\$86.7	\$77.8
Trillions of yen	¥-2.4	¥11.6	¥14.4	¥12.5	¥9.9
Percent of GNP	-1.0%	3.7%	4.3%	3.6%	2.7%
West Germany					
Billions of dollars	\$-13.8	\$16.3	\$38.1	\$44.2	\$41.4
Billions of marks	DM-25.1	DM47.4	DM82.4	DM79.3	DM69.2
Percent of GNP	-1.7%	2.6%	4.2%	3.9%	3.3%
Four Asian NIEs**					
Billions of dollars	\$-9.0	\$10.1	\$22.9	\$32.0	\$25-\$35
Percent of GNP	-6.8%	5.2%	10.2%	11.5%	8-10%

*Projected.

**Hong Kong, South Korea, Singapore and Taiwan.

Source: International Monetary Fund, World Economic Outlook, April 1988.

have emphasized the desire for dollar stability and a willingness to intervene in exchange markets to achieve that goal. Governments of the top industrial countries have also expressed the need to alter their macroeconomic policies in a coordinated fashion in order to achieve dollar stability and restore trade and financial balance in the world economy.

Although foreign exchange market intervention has been massive since 1985 -- first to push down the dollar in 1985 and, more recently, to support the dollar exchange rate, it is not clear how much underlying macroeconomic policies have been shifted in pursuit of the often-stated objective of restoring balance in the world economy. Nor is it clear what exactly is meant by macroeconomic "policy coordination."

This article describes policy coordination as an important component in the smooth adjustment of an integrated world economy. The study also shows that policy coordination -- at least on the monetary side -- has already gone a long way toward achieving better trade and financial balance among the major industrial countries.

Background: The Rise of Trade Imbalances

The strongest argument in support of macroeconomic policy coordination is to show its opposite effect -- the past pursuit of uncoordinated policies

has generated the lion's share of the recent trade imbalances and wide exchange rate fluctuations. Coordinated macroeconomic policies would, to a large extent, serve to redress the imbalances associated with these previously uncoordinated policies.

It is widely acknowledged that one of the most important elements behind the recent trade and exchange rate imbalances is that the United States has pursued fiscal policies diametrically opposed to those of Japan and West Germany since the early 1980s. The United States implemented a major tax reduction in 1981 that provided significant fiscal stimulus to the economy but also resulted in a string of unprecedented, large peacetime budget deficits. Japan and West Germany, in contrast, embarked on a period of fiscal restraint aimed at reducing their already large budget deficits.

The basic macroeconomic explanation for the causal linkages between budget deficits and trade deficits is by now well-known to academics and policymakers. The cut in U.S. taxes generated a rise in the budget deficit that needed to be financed. Conceptually, either a rise in net private domestic saving (private domestic saving less private investment) or a capital inflow from abroad (foreign saving) could have met this financing requirement.

The rise in the budget deficit in the United States was not accompanied by a substantial increase in net private domestic saving. On the contrary, the U.S. private saving rate remained low both by historical and international standards. U.S. private investment was moderately strong. To a large extent, therefore, foreign funds were relied on to finance the U.S. budget deficit.

The chain of events is familiar. Higher U.S. deficits and higher demand for credit put upward pressure on interest rates and generated a foreign capital inflow into the United States. This led to both the appreciation of the foreign exchange value of the dollar and the deterioration of the U.S. trade balance. U.S. fiscal stimulus also spurred the deterioration of the trade balance by boosting overall domestic demand relative to aggregate demand abroad, thereby causing purchases of imports to rise dramatically.

The upshot of these events was that U.S. exports -- hurt by the strong dollar and relatively weak demand from foreign nations -- stagnated while imports surged. Not only did the U.S. trade position deteriorate but real domestic demand (total purchases of goods and services) ran far ahead of total production (real gross national product) from 1981 until last year. The difference between production and sales was made up by increased imports.

In contrast to the United States, the rise in Japan's budget deficit in the second half of the 1970s coincided with a sharp rise in the net private saving surplus. The first oil-price shock was followed by an expansionary Japanese fiscal policy, a sharp fall in the rate of domestic investment and a fairly steady private saving rate. As a result, the savings needed to finance Japan's growing budget deficits were simply drawn from domestic sources that had financed heretofore strong investment demand. This was the reason that the shift in Japan's general public sector (all levels of government) from surplus in the early 1970s to a series of deficits peaking at the equivalent of 5.5 percent of GNP in 1978 did not result in foreign capital inflows and the associated trade deficits.

At the end of the 1970s, however, in a major policy shift, Tokyo adopted a restrictive fiscal stance in order to reduce the budget deficit and slow the growth of a public debt that had jumped fivefold since the mid-1970s. From a fiscal balance perspective, the restrictive stance was successful: the general government budget deficit was reduced to less than 1 percent (0.6 percent) of GNP by 1986 and it has remained at that level.

Nonetheless, one consequence of the lower general government budget deficit in the face of unabated strength in net private saving is that Japan has been flush with funds to lend to the rest of the world. Capital outflows from Japan, spurred by the deregulation of international financial transactions under the 1980 Foreign Exchange Law, were partially responsible for keeping the yen weak and for Japan's increasingly large trade surpluses. Surging Japanese exports found their way to world markets generally and to U.S. markets in particular, attracted by the strong dollar and the high growth of aggregate demand (associated with the fiscal expansion) after 1982.

A similar, though less dramatic, experience occurred in West Germany. Its general government budget deficit peaked at 3.7 percent of GNP in 1981. The systematic exercise of fiscal restraint gradually narrowed the budget deficit to 1.2 percent of GNP by 1986.

What is Macroeconomic Policy Coordination?

In the hope of redressing the imbalances that have plagued the world economy since the early 1980s, a number of policymakers and academics have suggested formal coordination of macroeconomic policies among the major industrial countries. Interpretations of the term "macroeconomic policy coordination" have ranged from simple consultation to clearly defined, mutual commitments by governments to alter their own policies in order to achieve a common objective or to help each government achieve its own objectives.

Consultation may be thought of as a weak form of policy coordination, involving the exchange of information among countries with a unilateral or collective commitment to act on the basis of the information. These information exchanges take place both formally and informally via bilateral meetings, international forums (e.g., G-5 and G-7 meetings) and in the context of international institutions (e.g., the International Monetary Fund and the Bank for International Settlements). Of course, these consultations are typically not simple information exchanges but involve interpretation of events and an attempt by governments to convince each other to alter their analyses and sometimes their preferences.

A more appropriate interpretation of macroeconomic policy coordination -- and the one that will be employed here -- denotes clearly defined, mutual commitments by governments to alter their own policies in order to achieve a common objective or to help each government achieve its own objectives. Such coordination involves a "package" of policy changes that would not take place in its absence. More precisely, one interpretation of macroeconomic policy coordination refers to an agreement by two or more countries to implement a set of policy changes that neither would wish to undertake on its own; each country expects the package to make it better off relative to the case where each sets its policies independently, taking the other's actions as a given.

Under this definition the gains from cooperation derive from the "spillover" effects of the other nation's actions, which presumably would not have occurred had the focus nation acted independently. These spillover effects may work either directly or indirectly. An example of direct spillover effects would be a coordinated expansion of aggregate demand abroad that expands international trade and generates export-led growth. An example of indirect effects would be when the home country is given the leeway to lower domestic interest rates and follow an expansionary monetary policy without depreciating its foreign exchange rate because other nations are following a similar policy in a coordinated fashion.

Back to Bretton Woods and Fixed Exchange Rates?

The Bretton Woods system of fixed exchange rates prevailing in the 1950s and 1960s often has been used as an example of macroeconomic policy coordination in the extreme: policies presumably had to be coordinated and synchronized to avoid balance of payments crises and revaluation of exchange-rate parities. Under the preferred interpretation of policy coordination, however, the Bretton Woods system would not have qualified. The reason is that under Bretton Woods the United States was clearly in the dominant position and largely set domestic macroeconomic policies independently of its major trading partners.

Europe, Japan and Canada under the Bretton Woods system were sharply constrained in their ability to follow independent policies because of their commitment to maintain fixed exchange-rate parities. Following a divergent, independent macroeconomic policy very likely would have generated significant international payments imbalances that, in turn, would have placed pressures on exchange rates. In this sense, the Bretton Woods system was not so much an example of successful policy coordination as it was an example of a fixed exchange-rate system where the dominant reserve-currency country set macroeconomic policies with little or no consultation with other nations, letting them adjust their own domestic policies to preserve the system of fixed rates.

The dominant position of the United States was also enhanced because the U.S. dollar was the primary reserve currency. Thus, the central banks of Europe, Japan and Canada were committed to buy or sell dollars on demand to finance international transactions imbalances as they arose. The United States, as a rule, did not play a major role in the day-to-day operations to maintain fixed exchange-rate parities, allowing the burden to fall on the non-reserve currency countries in the system.

The important point is that the countries involved did not agree to clearly defined, mutual commitments to achieve a common objective. The United States was the dominant party; it set policy largely independently to achieve its own objectives and, as the primary reserve currency nation, was not forced to buy and sell dollars on demand to maintain fixed exchange-rate parities.

The burden of policy coordination or, more appropriately, synchronization, was therefore placed primarily on Europe, Japan and Canada. Often these nations were constrained to follow policies perceived to be incompatible with their own best interests. In fact, the major reason the Bretton Woods system of fixed parities fell apart in 1971 and the Smithsonian agreement that replaced it collapsed in 1973 was that foreign nations became increasingly reluctant to follow the expansionary fiscal and monetary policy course being set by the United States and to suffer the inflationary consequences that followed.

Without macroeconomic policy synchronization, relatively large payments imbalances developed that had to be financed by central bank purchases of dollars in the foreign exchange market. The precariousness of this situation was soon seen by private-market participants, who expected a major devaluation of the dollar and, as a consequence, massive capital flows away from dollar assets to foreign currency assets. In the face of the huge international financial imbalances generated by "speculative" capital flows away from dollar assets (which were in addition to the underlying fundamental imbalances generated by uncoordinated macroeconomic policies), purchases of dollars through central bank intervention in the foreign exchange market were massive and soon became untenable. The system of fixed parities quickly collapsed as foreign central banks made the conscious decision to limit further dollar purchases rather than completely lose domestic monetary control.

How Would Macroeconomic Policy Coordination Work in Practice?

As opposed to the Bretton Woods system, true macroeconomic policy coordination would involve the major industrial countries setting mutually agreed on policies with the intent of achieving certain well-specified objectives. These objectives would presumably be negotiated and benefit all the parties to the agreement, although the distribution of the net gains from following coordinated policies would necessarily also have to be negotiated and may well vary over time depending on the economic circumstances.

The two major levers of macroeconomic policy are monetary and fiscal policies, where the latter encompasses aggregate government expenditures and tax policies as well as their composition. A secondary lever of policy is central bank intervention in foreign exchange markets. The primary levers -- monetary and fiscal policies -- would need to be set in a coordinated fashion, the particulars depending on the ultimate policy objectives. The primary policy levers would work to attain medium- and long-term objectives, while central bank intervention in foreign exchange markets (purchases and sales of foreign currency by central banks) would work to finance short-term imbalances and help maintain exchange rate stability.

Explicit Policy Rules Versus Broad-Based Discretionary Policy Actions

Once the objectives of policy have been agreed on, it becomes a technical matter as to what configuration of monetary and fiscal policies in the coordinating countries is likely to achieve these objectives. Technical economists, armed with simulations of large-scale internationally linked macroeconomic models, would present policymakers with the various alternatives. The policymakers then would negotiate simultaneously for a particular objective (in terms of exchange rates, trade balances, economic growth and inflation) and a set of policies designed to achieve that objective.

Although in principle this could be an enormous exercise -- evaluating multiple objectives and multiple policy configurations in a multicountry setting -- in practice it amounts to something such simpler. Policymakers are rightfully suspicious of the ability to fine-tune the economy with great precision and question the accuracy of very specific forecasts of the world economy. As a consequence, two basic approaches to policy coordination usually dominate discussions. The first is to set explicit policy rules by which monetary or

fiscal authorities are constrained. For example, containing exchange rate fluctuations within a narrow band is the constraint facing policymakers within the European Monetary System.

Prof. Ronald McKinnon has argued forcefully for one such proposal involving coordination by the United States, Japan and West Germany. He suggests a policy rule under which these nations would establish an average noninflationary money growth rate for themselves as a group and also share a mutual commitment to intervene in exchange markets to maintain fixed exchange rates. Each country's money growth rate would vary around the group average depending on whether its currency was under upward or downward pressure.

Countries whose currencies were under downward pressure would sell foreign exchange and buy their currencies in the foreign exchange market. This would contract their domestic money supplies, which then would grow at a rate below that set for the group as a whole. Countries whose currencies were under upward pressure would buy foreign currencies, sell their domestic currencies and expand their money supplies at a rate above the group average. Prof. McKinnon's proposal is "rule-based" and involves a commitment to maintain fixed exchange rates both through central bank intervention and the coordination of monetary policy in a symmetrical manner.

As opposed to explicit policy rules, the second basic approach to policy coordination is to agree on a broadly defined set of policies. Policy coordination, for example, may simply refer to one nation following a more expansionary aggregate demand policy by lowering interest rates through monetary stimulus, while another country agrees to a more contractionary aggregate demand policy implemented by lowering the domestic budget deficit. Either through specific rules or general policy actions, policies can be coordinated across nations in a very broad sense.

Coordination Since the Louvre Agreement

The February 1987 Group of Seven meeting at the Louvre is an example of broad-based policy coordination designed to help redress trade imbalances and exchange rate misalignments. The communique following the Louvre meeting stated that currencies were now "within ranges broadly consistent with underlying fundamentals." The governments agreed to stabilize the dollar both by altering their macroeconomic policies and by intervening in the foreign exchange markets to prevent "excessive" volatility. Since the Louvre G-7 meeting, central bank intervention in the foreign exchange markets has been massive. West German reserves jumped more than 50 percent last year, growing to \$78.8 billion from \$51.7 billion. Japan's reserves jumped more than 90 percent in 1987, climbing to \$81 billion from \$42.3 billion. Italy, the United Kingdom, France and Canada had similar gains from their attempts to hinder the fall of the dollar.

From the medium- and long-term view of macroeconomic policy coordination, however, the important point is that the central banks of West Germany and Japan have allowed a large part of their dollar purchases in the foreign exchange markets to have monetary effects (i.e., they have been "unsterilized") since the Louvre agreement. As a consequence, the monetary stances of both West Germany and Japan shifted and money growth in these nations has been rapid over the past year. In Japan the growth rate of the broadly defined money supply

(M2+CDs) has accelerated almost continuously since the beginning of 1987; for the October-December quarter it hit 11.8 percent -- the highest rate since the second quarter of 1979. Similarly, money growth in West Germany overshot target ranges for the second year in a row.

Supporting these moves, both the Bank of Japan and the Bundesbank lowered their central bank discount rates by 50 basis points in early 1987. Money market interest rates also declined in both countries; rates in Japan decreased from 4.18 percent in December 1986 to 3.2 percent recently, while rates in West Germany dropped from 5 percent to 3.2 percent over the same period.

These actions already have proved very successful, although this fact often is not sufficiently appreciated. As a direct consequence of monetary ease, real domestic demand last year grew by 5.1 percent in Japan and 2.8 percent in West Germany -- despite the rapid appreciation of their currencies against the dollar and the consequent negative contribution associated with net export deterioration. Real aggregate demand in the United States, in contrast, grew 2.5 percent -- down sharply from the 3.9 percent growth rate of 1986 (see Table 2).

Table 2: Indicators of Economic Performance for the United States, Japan and West Germany

(annual growth rates, in percent)

	<u>Actual</u>			<u>Projected</u>	
	<u>Average 1975-85</u>	<u>1986</u>	<u>1987</u>	<u>1988</u>	<u>1989</u>
Real GNP					
United States	2.6%	2.9%	2.9%	2.9%	2.7%
Japan	4.3	2.4	4.2	4.1	3.8
West Germany	2.0	2.5	1.7	1.7	1.7
G-7 Country Average	2.7	2.8	3.1	2.9	2.7
Real Domestic Demand					
United States	2.9	3.9	2.5	1.7	2.2
Japan	3.3	4.0	5.1	5.6	4.4
West Germany	1.8	3.7	2.8	2.7	2.0
G-7 Country Average	2.6	3.8	3.4	2.9	2.7
GNP Deflator					
United States	6.8	2.6	3.0	3.2	3.5
Japan	3.7	1.9	-0.1	1.2	1.5
West Germany	3.8	3.1	2.1	2.0	2.0
G-7 Country Average	7.2	3.0	2.7	2.9	3.0

Source: International Monetary Fund, World Economic Outlook, April 1988.

The maintenance of aggregate demand stimulus in Japan and, to a lesser extent, in West Germany, combined with the depreciation of the dollar exchange

rate, has had the desired effects on international adjustment: demand growth outstripped output growth in both Japan and West Germany (real GNP growth in 1987 was 4.2 percent and 1.7 percent, respectively, as shown in Table 2); the difference was made up by increased imports. As a consequence, the current account surplus dropped between 1986 and 1987 from 4.3 percent to 3.6 percent of GNP in Japan and from 4.2 percent to 3.9 percent of GNP in West Germany. The most recent International Monetary Fund forecast suggests that, with unchanged policy stances, Japan's current account surplus likely will drop to 2.7 percent of GNP this year and 2.5 percent in 1989 while Germany's current account surplus likely will fall to 3.3 percent this year and 3.1 percent in 1989 (see Table 3).

Table 3: Current Account and Saving-Investment Balance

(percent of GNP)

	Actual			Projected	
	Average 1975-85	1986	1987	1988	1989
United States					
Current Account Balance	-0.7%	-3.3%	-3.6%	-3.0%	-2.6%
General Government Fiscal Balance	-2.0	-3.5	-2.4	-2.2	-1.9
Gross Private Investment	16.3	16.3	16.0	16.1	16.1
Japan					
Current Account Balance	1.0	4.3	3.6	2.7	2.5
General Government Fiscal Balance	-3.5	-0.6	-0.8	-0.8	-0.7
Gross Private Investment	24.7	27.5	28.9	29.6	29.8
West Germany					
Current Account Balance	0.5	4.2	3.9	3.3	3.1
General Government Fiscal Balance	-2.9	-1.2	-1.7	-2.7	-2.3
Gross Private Investment	16.4	17.7	17.7	17.5	17.6
Seven Major Industrial Countries					
Current Account Balance	-0.2	-0.2	-0.4	-0.4	-0.3
General Government Fiscal Balance	-3.1	-3.2	-2.6	-2.4	-2.3
Gross Private Investment	18.1	18.4	19.9	19.5	19.9

Source: International Monetary Fund, World Economic Outlook, April 1988.

The burden of monetary adjustment so far has fallen on West Germany and Japan. The relatively expansionary U.S. monetary policy remained largely unchanged in 1987; a mid-year attempt to push interest rates up was abandoned after the October stock market collapse.

Fiscal policies also generally have moved in the right direction to help restore international balance. U.S. fiscal policy was sharply contractionary

last year. Between 1986 and 1987 the general government fiscal balance (all levels of government -- local, state and federal) improved from a deficit of 3.5 percent of GNP to -2.4 percent of GNP. IMF anticipates further reductions, projecting a 2.2 percent general government fiscal shortfall this year and only 1.9 percent in 1989.

The adjustment process also has been helped by moderately expansionary fiscal policies abroad. West Germany's budget deficit increased from 1.2 percent of GNP in 1986 to 1.7 percent in 1987 and is projected to rise sharply to 2.7 percent this year. Japan, in contrast, has maintained a roughly unchanged fiscal stance over the past two years. Japanese fiscal policy continues to be politically constrained by the long-term government objective of slowing the growth of the public debt. The introduction of a new indirect tax, such as the 3 percent general consumption tax now being discussed by the government and the Liberal Democratic Party, would further reduce the budget imbalance unless it is accompanied by cuts in other taxes. However, an increase in indirect taxation also would work against international coordination of fiscal policy.

On balance, however, monetary policies -- and, to a lesser extent, fiscal policies -- have moved in the right direction to help redress international payments imbalances since the Louvre agreement. The cooperative nature of the Louvre G-7 meeting was an important factor helping to coordinate macroeconomic policies among the major industrial nations.

Although overall financial imbalances are gradually being corrected, particularly in Japan and West Germany, one sore point remains: the current account deficit of the United States, unlike the surpluses of Japan and West Germany, is seemingly stuck at a high level. Both in nominal terms and as a percent of GNP, the U.S. current account balance deteriorated further in 1987. This development surprised and alarmed policymakers and analysts alike. Nonetheless, all signs point to significant current account and trade balance adjustments this year. The U.S. current account deficit should narrow from 3.6 percent of GNP in 1987 to 3 percent this year and 2.6 percent in 1989.

Who Should Coordinate Policies?

Once one accepts the argument in principle that some form of macroeconomic policy coordination is preferable to the present "non-system," a number of practical issues arise involving implementation. One question concerns which countries should participate.

There are tradeoffs between having too few countries formally participate and too many. One potential drawback of too few participants is that a major part of the world economy would be excluded from the coordination effort. This would limit the ability of the coordinating nations both to protect themselves from unforeseen external economic disturbances and to achieve common objectives that depend in part on a noncooperating trading partner. One potential benefit of having only a small group of countries involved, on the other hand, is that compromises on the objectives of coordinated policies presumably could be reached in a reasonable time frame. There also would be an increased probability that agreement could be reached on an appropriate set of policies to achieve these objectives.

In practice, coordinating the macroeconomic policies of the United States, Japan and West Germany -- similar to what has occurred since the Louvre

agreement -- very likely would prove sufficient to achieve a large degree of economic stability in the world economy. Coordination among the so-called "Group of Three" also very likely would prove sufficient to achieve their common macroeconomic objectives. There are several reasons for this. First, these nations together contribute a large share of the total real output of the members of the Organization for Economic Cooperation and Development. Second, as long as West Germany remains the dominant figure in the European Monetary System, the other EMS nations automatically would coordinate (or, as the term was used above, synchronize) their policies with those of West Germany, which in turn is working with the United States and Japan. The United States, Japan and the EMS nations make up more than four-fifths of the total GNP of the OECD countries and clearly would prove the dominant force in any economic fluctuations facing the industrial world.

Coordination With Different Policy Objectives

Perhaps the largest obstacle to policy coordination in the past has been real or perceived differences in the "policy objective functions" of different nations. Usually this is described in terms of the different sensitivities of governments to potential unemployment-inflation tradeoffs. It may also encompass different views on acceptable ranges of exchange rates and trade balances.

For example, the European Monetary System is a system of fixed exchange-rate parities around a narrow band that repeatedly comes under pressure for adjustment because macroeconomic policies frequently are uncoordinated. A continual point of contention in the EMS when imbalances arise is the appropriate combination of devaluation by the deficit countries and revaluation by the surplus countries. A second point of contention is whether the burden should be placed solely on exchange rate adjustments or on a mix of exchange rate adjustments and macroeconomic policy adjustments -- either expansionary aggregate demand policies in the surplus countries or contractionary aggregate demand policies in the deficit countries.

Traditionally, the burden of adjustment has fallen primarily on the "weak" currency country experiencing deficits. It usually has taken the form of currency depreciation and a contraction in aggregate demand, which generally is implemented by both tightening monetary policy (typically by directly raising interbank interest rates) and raising taxes and cutting government expenditures. Within the EMS, however, the deficit nations have been increasingly reluctant to bear the entire adjustment burden; as a consequence, intense negotiations have followed and compromises acted on.

It is not likely to be a simple task for nations to agree on a common set of objectives as a first step toward coordinating policies. This is primarily a political problem, not an economic one. It is often politically unpopular to implement policies that in the short term have adverse employment and output consequences or are viewed by the public as implemented primarily because of domestic acquiescence to foreign pressure. But it must be kept in mind that there have been reasonably successful attempts at a very high degree of economic policy coordination (e.g., the EMS). The primary reason so much attention has been focused on policy coordination over the last two years or so is due to the perception that the present "non-system" has costs, both politically and economically, that presumably outweigh those of a system of coordinated policies.

The Benefits Outweigh the Costs

It is not likely to be an easy task to systematically coordinate macroeconomic policies internationally. This is not surprising considering the internal political difficulties every nation typically faces in attempting to design an internally consistent set of monetary and fiscal policies. But economic events since the beginning of the 1980s -- large and growing trade imbalances, wide swings in real and nominal exchange rates and recurring trade and industrial dislocations -- suggest that an alternative to the present "non-system" is desirable. Moreover, the experience of the past two years indicates that broadly defined, loose coordination of macroeconomic policies is not only good politics -- by helping to avert protectionist pressures associated with unrelenting trade imbalances -- but also good economics. The loose coordination of policies agreed to at the February 1987 Louvre G-7 meeting already has helped to restore trade, financial and exchange-rate equilibrium in the world economy. Moving back to uncoordinated and often divergent policies will only make matters worse.

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J A P A N · E C O N O M I C · I N S T I T U T E

JEI

R E P O R T

A Two-Part Report: A and B

NO. 25B
July 1, 1988

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Weak Dollar Pulls Down Japanese Import Prices

American policymakers had high hopes for U.S. exports to Japan when the dollar started to drop against the yen in 1985. Their thinking was that more or less constant dollar prices would translate into lower prices in yen, leading to larger sales and more profits for American exporters. Recently, some American observers have argued that the process is not working right; somehow the benefits of the dollar's decline are not reaching the Japanese consumer in the form of lower prices so that sales, while up, are not as high as they might be. If true, this argument would parallel the complaint that Japanese exporters are not raising prices in the American market to reflect the yen's rise (see JEI Report No. 10A, March 11, 1988). Less-than-hoped-for U.S. exports to Japan would combine with the almost constant level of imports from Japan to keep the bilateral trade balance at close to its old level.

Washington may have had unrealistic expectations from the beginning. In competitive markets, firms price according to the competition; if their rivals keep prices low, they will have to follow. But if their competitors stick with high prices, they would be foolish to cut prices dramatically. For American firms selling in Japan, for example, there would be no reason to slash prices significantly if they are only second-tier suppliers of a standardized product dominated by Japanese makers; trimming prices a little should be enough to sell much larger quantities. This suggests that a large drop in the dollar is unlikely to lead to corresponding declines in the Japanese price of such American goods. In those areas where American companies face less competition from Japanese firms, larger price cuts are more likely.

Table 1 shows the extent to which foreign firms have passed through the currency changes since September 1985 in the yen prices they charge in the Japanese market. As textbook economics suggests, in many instances the full benefits have not been passed on to Japanese distributors. However, the data also show that prices in yen have fallen substantially for the products listed.

Table 1: Percent of Dollar's Decline Passed Through in Import Prices*

<u>Product Group</u>	<u>September 1985- April 1988</u>
Food	72.7%
Clothing	48.4
Organic Chemicals	49.7
Inorganic Chemicals	82.4
Steel	53.3
Aluminum and Alloys	19.2
Nonelectric Machinery	84.7
Electric Machinery	102.2
Semiconductors	73.9
Transportation Equipment	63.6
Aircraft	82.8

*The dollar declined 90.4 percent against the yen during this period.

Source: Calculated from Japan Tariff Association, The Summary Report: Trade of Japan, April 1988.

Compared to Japanese products in the United States, a large proportion of Japan's imports consists of industrial and agricultural inputs and the prices of these commodities reflect changing supply and demand throughout the world. This characteristic makes interpreting pass-through statistics more difficult. Some goods, such as aluminum, have risen in dollar price during the past year. The appreciation of the yen has not been enough to offset this; the yen price has risen as well, reflected as a negative pass-through between April 1987 and April 1988. Other goods, whose prices have dropped on world markets, show pass-throughs exceeding 100 percent. These short-run, commodity-like swings in prices tend to even out over the longer period used in Table 1.

These data are only part of the picture, however. Lower import prices, if any, may not be passed on to the consumer if the distributor increases its margins. Conversely, competition could increase or distribution costs could fall as the imports are distributed in larger quantities, leading to lower margins and more than a 100 percent pass-through of the import price drop. Japanese government data suggest that, depending on the product, both phenomena are occurring (see Table 2). While the prices of goods such as guitars have been

Table 2: Comparison of Import and Retail Price Changes,
September 1985 and April 1988

<u>Product</u>	<u>Reduction in Import Price*</u>	<u>Reduction in Retail Price*</u>	<u>Retail Price Change/ Import Price Change</u>
Photographic Film	Y76	Y30	39%
Bananas	27	14	52
Guitars	82,353	50,000	61
Records	802	530	66
Umbrellas	119	90	76
Coats	6,266	5,000	80
Dress Shirts and Blouses	209	200	96
Jeans	381	400	105
Electric Razors	666	700	105
Cars	74,815	80,000	107
Tennis Rackets	4,120	4,640	113
Grapefruit	87	116	133
Handbags	340	500	147
Wine (American-made)	237	350	148
Exercise Balls	142	210	148
Compact Disks	182	300	165
Shrimp	764	1,290	169
Fountain Pens	2,717	5,000	184
Wind Instruments	19,470	36,000	185
Fans	1,500	2,820	188
Golf Clubs	24,858	48,000	193
Firecrackers	5	10	200
Tires	4,686	9,400	201
Underwear	94	200	213
Household Aluminum Articles	465	1,030	222
Toys	512	1,200	234
Canned Sweet Corn	71	200	282
Neckties	469	1,500	320
Lemons	283	927	328
Wrist Watches	2,440	8,400	344
Socks	25	100	400
Whiskey (standard)	178	775	435
Natural Cheese	76	396	521
Whiskey (premium)	321	2,350	732
Down Mattresses	13,319	110,000	826
Eyeglasses	196	5,000	2,551

*Per unit price change in yen except for food items, which are per kilogram.

Source: Nihon Keizai Shimbun, June 3, 1988.

reduced by less than the fall in import prices, other prices have been cut much more. Most dramatically, the import price of eyeglasses dropped only Y196 (\$1.57 at Y125=\$1.00), but the retail price plummeted Y5,000 (\$40).

Adding the changes in import prices with price cuts at the retail level, the Ministry of International Trade and Industry, one of the four government agencies that conducted the pricing survey, estimated that the retail prices of goods from the United States fell an average of 26 percent during the September 1985-April 1988 period. This suggests that, for a broad array of products, U.S. and other exporters have cut their prices in the Japanese market and those lower prices are finding their way to the Japanese consumer.

Douglas Ostrom

Japanese Banks At Top But Still Scrambling

According to a special survey in Business Week, the five top banks in the world in terms of assets are Japanese. Moreover, Japanese banks occupy seven of the top 10 positions and account for 21 among the top 50. Nevertheless, Japanese banks are scrambling to comply with tough capital-to-asset ratios set by the Bank for International Settlements in an attempt to even the playing field in global banking and to enhance the soundness of banks around the world. Japanese banks are instituting new policies, such as tightening up on poorly performing loans and issuing large amounts of new shares, that will have an impact on the Japanese banking system and financial market.

According to the Business Week study, three factors combined to improve the positions of Japanese banks between 1986 and 1987. Their assets, measured in dollars, were magnified by the yen's appreciation last year. The resurgent Japanese economy, combined with steady inflation and gradual interest rate liberalization, led to higher net income. In addition, U.S. banks took large write-downs and set aside even bigger reserves for loans to developing countries, both of which dented profits. After taking into account the differences in national accounting practices and portfolio structures, the study concludes that the "real profitability" of Japanese banks was average in 1987. This runs counter to the often heard complaint that Japanese banks pursue market share rather than profit.

Nevertheless, Japanese banks are concerned over the BIS guidelines. Under the December 1987 BIS requirements, commercial banks in all member countries must raise their core capital (common equity capital and disclosed reserves) to 4 percent of total assets; total capital (core capital plus 45 percent of the current market value of stocks and bonds or other hidden reserves) must be at 8 percent by 1992. Japanese banks' core capital ratios range from 2 percent to 3.5 percent; their total capital ratios are between 4 percent and 6 percent. Under transitional rules, banks must attain levels of 5 to 6 percent for core capital and 7.25 percent for total capital by the end of 1990. Japanese banks are taking several approaches:

- Issuing new stock or convertible debt instruments to increase shareholder equity. Dai-ichi Kangyo Bank, Ltd. issued 40 million shares in September 1987, a record broken by the Bank of Tokyo, Ltd. this April when it offered

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R E P O R T

A Two-Part Report: A and B

NO. 27A

July 15, 1988

U.S. IMPORTS FROM JAPAN: A REVIEW OF 1987 SALES

Summary

The volume of U.S. purchases from Japan finally dipped in 1987, but it took more than the dollar's 53 percent drop against the yen between February 1985 and the end of the year to trim price-adjusted imports from this country's biggest foreign supplier. Consumer spending on cars, home electronics and other durables, which had increased at a heated pace during the first four years of the current expansion, cooled in 1987, putting a major damper on sales of made-in-Japan products. Along with the continuing cap on Japan's U.S.-bound car and steel shipments, new restraint arrangements for machine tools and textiles also reined in the growth of imports. Expanded Japanese production in the United States helped at the margin. At the same time, strong demand at home reduced the pressure on Japanese manufacturers to push exports to their largest overseas market.

The failure of the huge dollar-yen realignment to single-handedly cut imports from Japan provides clues to why the total volume of U.S. offshore purchases is still rising more than three years after the dollar peaked in value on foreign exchange markets. For starters, Japanese manufacturers, opting to protect their stake in the key American market rather than maintain profit margins, passed through only about half of the dollar's drop in the form of higher U.S. prices. These markups blunted the competitive edge of Japanese exporters in a range of business lines but rarely dulled it, in part because domestic producers in a cross section of industries raised their prices as well. Nonprice competitive factors also propped up imports from Japan. Moreover, the strength of U.S. manufacturing output in 1987 pulled in industrial inputs either not available here or in short supply. The

growth of business investment in computers and other equipment had the same effect.

For purchases from Japan, the relative weight of these opposing forces varied considerably across the four major end-use product categories. In a major turnaround, consumer goods contracted 13.4 percent to \$13.4 billion, while the growth of automotive products was sliced to just 2.6 percent for a total of \$33.7 billion. Staging a reversal of its own, intermediate goods went up 4.8 percent to \$7.3 billion. Capital goods, though, stayed on a fast-paced expansion path, advancing by an additional 14.3 percent to \$29 billion. On balance, imports of Japanese-made products increased 3.3 percent last year to \$84.6 billion -- a major improvement on 1986's 19.1 percent gain.

Automotive Products

Cars - By driving up sticker prices in 1987, the weaker dollar caused the first year-to-year cutback in the volume of cars imported from Japan since U.S.-bound shipments were capped in April 1981. That at least was the conventional wisdom. But higher prices were just one reason car deliveries were down by 200,000-plus units or 7.7 percent to 2,417,509 vehicles on a 1.2 percent value gain to \$21.3 billion -- and not necessarily first on the list. In many respects, soft car demand was the major problem. Consumers bought 42.1 million cars plus 15.8 million light trucks during the spending spree that propelled the expansion of the U.S. economy over the 1983-86 period. Having satisfied much of the pent-up demand from the 1980-82 recession, they scaled back the growth in their purchases of durables last year. Moreover, some late 1986 car sales were borrowed from 1987's first half because of the coming elimination of the sales tax deduction under tax reform. At the same time, Detroit's almost nonstop use of factory-to-dealer incentives, buyer rebates and/or low-cost financing to move slow-selling models added to the marketing headaches of Japan's automotive manufacturers and their American distributors. So did increased competition from Hyundai Motor Co. in the market's low end, where both General Motors Corp. and Ford Motor Co. introduced an entry-level car made in Korea.

Whatever the ranking of these developments, one thing was clear: Japanese car dealers were fighting an uphill battle for sales in 1987. The inventory numbers for Japanese imports were proof of that. Stocks equal to a 20- to 25-day supply were the norm during the 1983-85 sales boom. Last year, though, inventories in most months ran close to a 60-day supply -- a figure not seen since Tokyo decided to limit car exports to the United States. Honda Motor Co., Ltd.'s U.S. dealers could still sell all the cars they received from Japan -- and at prices generally above list in major metropolitan areas. The same was true for Toyota Motor Corp.'s distribution network, which handles the number-one import make.

Mazda Motor Corp. managed to get its stocks below the industry average in the second half of 1987, but the inventory figures for other Japanese manufacturers looked like those for domestic makers during a slump. Nissan Motor Co., Ltd., the number-three import nameplate, Fuji Heavy Industries, Ltd. (which makes Subaru vehicles), Mitsubishi Motors Corp. and Isuzu Motors Ltd. rarely had less than a 60-day supply of cars on hand and often had anywhere from 90 to 120 days. GM and Chrysler Corp. also had trouble keeping their import stocks in check, with GM's supply of cars built by Isuzu and Suzuki Motor Co., Ltd. bouncing between 90 and 163 days and Chrysler's inventories of MMC-produced cars stuck in the 80- to 131-day range.

Inventories first started to pile up in the summer of 1986. That timing was no accident. Four rounds of price hikes since September 1985 had boosted the stickers on Toyota, Honda and Nissan cars by \$1,300 on average or roughly 13.7 percent, according to Automotive News. Four subsequent increases -- at the beginning of the 1987 model year, again in February/March 1987 and June/July and then at introduction time in the fall -- accelerated the stock buildup last year. In all, Toyota's prices were up by an average \$2,717 or 23.8 percent from the end of the 1985 model year, Honda stickers were \$2,509 or 25.1 percent higher and Nissan models were \$2,558 or 26.1 percent more expensive.

When inventories started to mount in 1986's second half, Japanese dealerships scrapped the pricing policies that had earned them fat profits in the boom years. First to go were the hefty markups added to the list prices of the most popular models in major import sales markets. Then dealers across the country began to discount prices on their slowest-selling models. With sales still lagging in early 1987, importers of Japanese cars finally bowed to what automotive industry analysts considered the inevitable and started to offer incentives to move selected models. Actually, the first cracks in the wall of resistance to car incentives had appeared in late 1986 when Mitsubishi launched a cash-to-dealer program and Isuzu introduced direct incentives for buyers of 1986 model cars. Toyota, Nissan and Subaru marketers joined MMC and Isuzu in providing dealer incentives in the first part of 1987 and Mazda climbed on the bandwagon in the spring, leaving Honda as the lone holdout. But only Mazda followed Subaru's expensive step of offering cash incentives to car buyers.

These moves mitigated some of the sales-dampening effects of higher sticker prices. So did Detroit's pricing strategies. The run-up in Japanese car prices triggered by the weaker dollar gave the U.S. Big Three a second chance to regain market share from their trans-Pacific rivals. GM and Ford squandered this opportunity during the 1986 model year, hiking prices by almost the same average dollar amount as Toyota, Honda and Nissan. Pricing of 1987 models at introduction reflected the same strategy of keeping profit margins fat even at the expense of sales, with GM and Ford again matching nearly dollar for dollar the average increases announced by the leading Japanese importers. U.S. manufacturers did hold the line when Japanese car prices were raised during the model year, but whatever competitive edge Detroit gained was short-lived since list prices went up again last fall. On paper the increases were modest. In reality they topped the average markups on 1988 model Japanese cars by big margins, both on a percentage basis and dollar-wise, as all three American car companies made standard much equipment that had been optional and upped prices accordingly.

The Big Three made another killing in 1987, earning a near-record \$9.5 billion despite their costly incentive programs. In the process, though, they

helped the competition market more cars than otherwise might have been possible given last year's combination of soft demand and higher prices. "More" still meant that sales of made-in-Japan cars fell short of the record set in 1986 by 213,689 units or 9 percent. But with sales of 2,158,800 vehicles, Japanese imports supplied 21.1 percent of the market in 1987 compared with 20.7 percent the year before, as retail deliveries of domestic makes dropped 13.8 percent to 7,081,262 units.

Trucks - The conventional wisdom was on firmer ground in linking 1987's contraction in Japanese-made truck imports to price pressures caused by the weaker dollar. But here, too, something else was at work as arrivals tumbled 20.9 percent to 771,802 vehicles and their value fell 13.5 percent to under \$4.2 billion. Ironically, that extra factor was smart product development and marketing by Detroit. Having stood by in the late 1970s while Japanese automotive makers carved out an expanding U.S. market for compact pickup trucks, the Big Three countered in the early and mid-1980s with a versatile lineup of downsized pickups, sports/utility vehicles and vans. An immediate hit, these products kept total U.S. sales of small trucks on a record-breaking course starting in 1982, in part by spurring a growing crossover of car buyers.

On the defensive, Japanese producers successfully fought back, increasing sales volume every year through 1986 despite the added handicap of a 25 percent duty on imported trucks. The key to their success was aggressive pricing of base pickup models, which were maintained at \$5,999 during the 1982-85 period. The backup was liberal use of incentives, whether cash to dealers or cut-rate financing and rebates to buyers, whenever sales slowed. The Japanese competition also added features to their pickup models to meet a wider variety of passenger, cargo and performance requirements and, at the same time, moved into the fast-growing market for small sports/utility vehicles.

Japanese pickup truck manufacturers stuck with their proven sales formula in 1987, but this time around it failed them. Although importers generally raised truck prices by smaller margins than car prices as the dollar dropped, round after round of markups started to pinch sales. The stickers' on price-leader pickups were increased by either \$300 to \$6,299 (Isuzu and Mitsubishi) or \$600 to \$6,599 (Mazda, Nissan and Toyota) when the 1987 models were introduced in the fall of 1986, and they went up two more times during the model year and again when the 1988 models were unveiled. GM, Ford and Chrysler raised prices as well, but their hikes were much smaller than the cumulative 1986-87 increases of \$600 to \$1,100 on Japanese base models. Detroit also repeatedly demonstrated that it could more than match the competition in the use of incentives.

Sales of compact Japanese sports/utility vehicles managed to escape the twin negatives of higher prices and stiff U.S. competition in 1987, jumping 52.4 percent to 201,976 units; so did vans. Pickups, however, took a beating, dropping 19.5 percent to 623,305 vehicles, which pulled down total sales of Japanese truck nameplates 8 percent to 865,471 units. And that was just the start of the good news for Detroit. Paced by an 18.5 percent jump in sales of downsized pickups to 781,992 units, combined retail deliveries of small American trucks advanced 13.3 percent last year to 1,916,741 vehicles. In the process, the domestic industry rolled back Japan's market share by a substantial 4.6 points to 31.1 percent.

Parts - While Detroit was making more money selling fewer vehicles, American makers of original equipment automotive parts were hard-pressed to keep earnings from falling farther. Their bottom lines are primarily determined by the level of North American production of cars and trucks by U.S.-headquartered manufacturers, and that number was down again in 1987. Output totaled 11.7 million vehicles, 0.7 million units short of the 1986 tally and 20 percent below what the industry still regards as the benchmark -- 1978's all-time-high production run of 14.6 million units.

The Big Three's slow but steady switch to independent parts suppliers was no help. Not only was there less volume to outsource but more competition from abroad for that reduced business. The dollar moved little if at all against the national currencies of low-wage countries, enabling their producers to maintain a big price edge in the thousands of labor-intensive parts that go into cars and trucks. Moreover, the cost-cutting steps that Japanese parts suppliers took to facilitate the adjustment of the domestic motor vehicle industry to the weaker dollar allowed them to remain competitive in the export market.

Detroit's continued sourcing of powertrain products and other major mechanical components from firms in Japan was one reason imports of motor vehicle parts and accessories jumped again, this time by 22.4 percent to \$7.4 billion. A bigger factor, though, was another increase in Japanese transplant production -- shorthand for the vehicles assembled in the United States by Japan's automotive manufacturers. In 1987 Honda of America Manufacturing Inc., Nissan Motor Manufacturing Corp. U.S.A., New United Motor Manufacturing Inc. (the Toyota-GM venture) and newcomer Mazda Motor Manufacturing (USA) Corp. turned out a total of 735,694 vehicles, 108,418 units more than the year before and double 1985's output.

Although the four assembly operations are steadily qualifying additional U.S. makers of original equipment, they still bring in engines, transmissions, differentials or transaxles, electronics and other key components from Japan. Continued dependence on parent companies or affiliated suppliers at home for major production parts has an obvious impact on the import numbers: purchases expand basically in tandem with the growth in transplant output. But this sourcing pattern also has a big indirect effect on imports. Well over 100 Japanese parts producers have opened U.S. plants to supply Honda, Nissan, NUMMI and Mazda as well as two transplants doing trial production (Toyota and a joint venture between Mitsubishi and Chrysler), and they depend on subassemblies and individual parts brought in from Japan to operate their American factories.

Despite all the attention focused on transplant sourcing from Japan and Big Three OE purchases there, this business is thought to represent less than half of U.S. imports of Japanese-made parts. The biggest volume of trade -- and, fragmentary information suggests, the fastest growing -- is in replacement parts, primarily for Japanese vehicles. With Japanese models accounting for roughly 15 percent of the cars and trucks on American roads, the aftermarket for these vehicles is sizable. Domestic manufacturers are the main suppliers of batteries, tires, spark plugs, filters, mufflers, brake parts and other high turnover parts distributed through automotive repair shops, mass merchandisers and other nondealer channels, but Japanese competitors apparently held their own last year, the weaker dollar notwithstanding. The dollar-yen realignment also did not help the American industry break the near stranglehold of Japanese

vendors on the parts operations of Japanese car and truck dealers. While the dealer network handles well under 50 percent of the service and repair parts for Japanese vehicles, this is the primary U.S. distribution channel for mechanical components and other high value-added products.

Capital Goods

Computer Equipment - American capital goods manufacturers counting on the weaker dollar to help them regain part of the business they had lost to Japanese competitors during the first half of the 1980s were frustrated again last year. As the 35 percent jump in computer equipment purchases to \$6.4 billion graphically demonstrated, imports from Japan were generally immune to exchange rate shifts. Immune, that is, in the conventional sense. The continuing decline in the dollar did accelerate the transfer of production from Japan to the United States, both by Japanese makers and U.S. producers dependent on Japanese manufacturing. In the trade statistics this move showed up in the above-average growth of parts imports in most capital goods product lines as American and Japanese competitors alike switched some of their sourcing from finished products to parts for U.S. assembly.

In the computer field this switch produced a 48.8 percent surge in parts imports to \$2.9 billion. Roughly half of the gain reflected expanded purchases (\$1.3 billion worth) of parts for memory devices, with an almost even split between the growth in parts for hard and floppy disk drives. Surprisingly, this expansion did not dent imports of drives from Japan. Imports jumped 43.6 percent to \$0.5 billion on a larger volume increase -- one sign that pricing remained aggressive. Japanese vendors tightened their control of the U.S. market for low-capacity 5.25-inch hard drives used with personal computers, while extending their lead in the far bigger market for 5.25-inch flexible drives and the fast-expanding one for microfloppies.

Parts for printers were also up strongly, but this business was only one-fourth the size of disk drive parts imports. The big trade continued to be in the finished product. At \$1.7 billion, purchases of printers were 32.8 percent above the 1986 figure. Lasers were the most dynamic import segment, reflecting the growing popularity of desktop publishing and the enhanced graphics capabilities of personal computers. But U.S. demand for dot-matrix printers for use with PCs and workstations remained strong. With Japanese manufacturers the dominant suppliers of these machines, imports hit 4 million units valued at \$0.9 billion.

While Japanese companies extended their already deep inroads in the U.S. market for microcomputer peripherals last year, they were once again stymied in their attempt to gain share in the market for IBM-compatible PCs. International Business Machines Corp. admittedly created another stumbling block for Japan's computer industry by introducing a new line of PCs that is difficult to reverse engineer, but other manufacturers of compatible systems based on the old technology increased shipments in 1987. This fact was perhaps the final blow to the commonly held opinion that Japanese makers would become major players in the American personal computer market once the IBM PC became a commodity product.

Japanese manufacturers have made their mark on one segment of the U.S. microcomputer market -- portable and laptop computers. Their success backfired

in April 1987 when the Reagan administration slapped 100 percent penalty tariffs on these products in retaliation for Japan's failure to implement fully the bilateral semiconductor trade pact. Rather than walk away from this rapidly expanding market, the leading suppliers started U.S. assembly operations, which gave another boost to the computer parts import number.

Semiconductors - The return of double-digit growth to the personal computer market after a two-year pause plus higher sales of mainframes and mid-range systems and related peripherals fueled the comeback of the struggling American semiconductor industry. It also boomeranged on domestic computer makers. U.S. chip orders, which had rallied in 1986 from their anemic 1985 levels, were above shipments for the year's four quarters. For most products the recovery simply meant firmer prices and slightly longer delivery times. But in DRAMs (dynamic random access memories), a market dominated by the Japanese competition, prices jumped and shortages developed, both for the workhorse 256K device and the state-of-the-art 1-megabit chip.

Strengthening demand was only part of the problem in DRAMs. To stamp out dumping of these products in third countries, the Ministry of International Trade and Industry told semiconductor makers in February 1987 to reduce production. The cutback slowly dried up excess supplies on the Japanese market and in the process pushed up DRAM prices in the United States, where quotes on Japanese-produced chips had already jumped to meet the pricing guidelines set by Washington as part of the July 1986 U.S.-Japan semiconductor trade accord.

Barraged by complaints from American computer makers about inadequate DRAM supplies, MITI lifted the production controls in the early fall. This did not end the shortage. For the year U.S. deliveries of Japanese-made memories, including EPROMs (erasable programmable read-only memories) and static RAMs as well as DRAMs, increased 16 percent. The import value, however, climbed 50.3 percent to \$1 billion, swelling overall semiconductor purchases from Japan by 34.6 percent to \$1.7 billion.

Machine Tools - U.S. machine tool builders continued to struggle last year. The improved outlook for domestic manufacturers of durable goods did not help them. Neither did new restraint arrangements with Japan and Taiwan, although the limits on shipments of Japanese-made machining centers, computer numerically controlled lathes and CNC punching and shearing machines trimmed imports 8.3 percent to under \$1.2 billion. The U.S. industry's orders were no better than 1986's bookings, themselves more than one-fourth below the 1984 numbers. Moreover, shipments dropped even with another reduction in the backlog of unfilled orders.

American machine tool suppliers argued that the restraint agreement with Japan did not enable them to regain business from their rivals because there was a substantial inventory of Japanese-made products in the United States when the pact went into effect January 1. To move this inventory, they added, Japanese pricing remained aggressive despite markups in list prices to cover part of the fall in the dollar's value. But this argument had a fundamental flaw. Having largely retreated from the market for small and medium-size CNC lathes and machining centers -- the products making up most of the inventory overhang, U.S. builders were not in a position to compete for the contracts won by Japanese suppliers.

Consumer Goods

The decline in shipments of Japanese-made cars and trucks is a good test of the proposition that price hikes tied to the weaker dollar were not the only cause of the reduced 1987 volume of imports from Japan or necessarily the major factor. The drop in line after line of consumer electronics products provides an even better case study. Japanese manufacturers wished they had the luxury of raising U.S. prices by more than the 15 percent or so markup that occurred in 1986 and last year's increase in the single-digit range since profit margins, always thin in the cutthroat consumer electronics business, had been pared to the bone by the dollar-yen realignment. Suppliers, however, were boxed in.

With consumers finally applying the brakes to spending on durables in 1987 after a four-year buying spree, retailers of audio and video equipment had a hard time keeping sales at 1986 levels. Part of the problem, industry executives acknowledged, was that no new product had appeared on the market to take the place of videocassette recorders, the premier home electronics growth product of recent years. Sales of VCRs had slowed in 1986 despite another round of price-cutting; last year they fell as the number of American households with VCRs approached the 50-percent mark. A few products were still hot sellers, like camcorders (portable video camera-recorder combinations), giant screen (26 inches and larger) table and console color televisions and compact disk players. But overall demand was not strong enough to allow Japanese manufacturers to push through an across-the-board price increase of any magnitude and make it stick.

While soft demand put a lid on sales and imports, Japan's consumer electronics industry had only itself to blame for a big part of the deep cutback in shipments. Ignoring signs in 1986 that the days of go-go growth in the U.S. audio and video market were numbered, producers kept moving more products into the pipeline. This was particularly true of VCRs, but it applied as well to other types of equipment. When demand slowed as predicted, exporters were forced to make enormous adjustments. VCR shipments alone were reduced by 5.5 million units or one-third to 11.4 million, which sliced the import bill by 39.5 percent to \$2.6 billion. In all, U.S. purchases of Japanese-made consumer electronics equipment dropped by close to \$2 billion to roughly \$8.2 billion.

Intermediate Products

Japan's steel mills were in a bind of their own last year but of a different kind. U.S. steel demand, while still less buoyant than in the late 1970s, picked up some strength in 1987, but Japanese competitors were not able to capitalize on this upturn. Even if a belated round of price increases had not handicapped them, the quota on U.S.-bound shipments would have. Under a five-year arrangement starting in October 1984, Japan's exports of carbon steel products to this country are limited to 5.8 percent of apparent American consumption. As it turned out, Japanese producers supplied just 4.7 percent of this dominant market segment in 1987, down 0.4 point from the year before. Overall shipments were off 2.3 percent to 4.3 million tons valued at \$2.2 billion, with mills in Japan covering only 4.5 percent of total domestic demand -- their smallest share since 1965.

Japanese steel makers did manage to increase volume in a few product lines, including structural shapes and coated plates and sheets. But with the exception of the latter line, their normally big business in flat-rolled products was hamstrung, in part by the restraint agreement but also by the drop in production in the U.S. automotive industry -- steel's biggest customer -- and flat demand from appliance manufacturers. At the same time, stronger orders from the oil and gas industry had no spillover effect on depressed shipments of Japanese-made tubes and pipes.

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The views expressed in this report are those of the author and do not necessarily represent those of the Japan Economic Institute.

U.S. Imports from Japan by Commodity, 1986 and 1987
(in millions of dollars* and indicated quantity units)

Commodity	Quantity		Value		Percent Change 1986/87	Japan's Share of U.S. Imports 1987
	1986	1987	1986	1987		
Total Imports			\$81,911.1	\$84,575.0	3.3%	20.8%
Automotive Products						
Cars	2,618,709 no	2,417,509 no	32,849.1	33,694.9	2.6	39.5
Assembled Trucks	975,613 no	771,802 no	21,060.1	21,304.7	1.2	44.5
Truck and Truck Tractor Chassis	3,798 no	7,306 no	4,807.3	4,156.8	-13.5	52.3
Truck Bodies (incl. cabs)	9,772 no	10,042 no	57.1	95.3	66.9	9.3
Truck Tractor Bodies	2,270 no	607 no	97.3	121.4	24.8	55.7
Automotive Parts, Accessories and Engines			31.8	8.8	-72.3	26.0
Body Stampings			6,065.6	7,427.2	22.4	27.7
Bumpers			197.9	264.6	33.7	61.0
Wheels			53.8	52.0	-3.5	15.7
Radiators			109.3	108.8	-0.5	24.6
Mufflers and Tailpipes			33.2	28.6	-13.9	18.2
Brakes and Parts			52.1	67.1	28.8	30.1
Transmissions			92.6	129.4	39.7	14.5
Shock Absorbers			513.1	616.8	20.2	36.8
Engines and Parts			29.5	66.2	124.4	44.0
Engines	653,191 no	784,178 no	885.4	1,219.1	37.7	24.7
Parts			638.7	875.7	37.1	24.5
Starting and Ignition Equipment			246.8	343.4	39.1	25.1
Battery Charging Generators			243.4	284.6	16.9	39.2
Starting Motors	1,071,208 no	1,574,314 no	29.5	46.8	58.6	29.8
Spark Plugs	1,962,186 no	2,789,679 no	64.0	85.7	33.9	63.3
Ignition Wiring Sets	428,182,000 no	563,309,000 no	29.6	35.8	20.9	46.6
Pumps			76.5	118.1	54.4	10.8
Fans and Blowers			78.7	79.3	0.8	28.8
Electric Lighting Equipment			19.6	28.7	46.4	28.1
Lead-Acid Batteries and Parts			67.3	85.0	26.3	25.9
Tires			34.1	41.8	22.6	30.4
Car Tires	8,496,980 no	9,217,145 no	475.6	492.2	3.5	25.9
Truck and Bus Tires	2,113,340 no	2,238,164 no	243.0	256.2	5.4	24.6
Radios	626,143 no	630,372 no	232.6	236.0	1.5	27.5
Toughened and Laminated Glass			38.7	35.6	-8.0	10.8
Metal Hinges, Fittings and Mountings			31.7	35.9	13.2	9.6
Springs and Leaves for Springs			49.8	51.0	2.4	16.3
Furniture			22.1	25.1	13.6	10.3
Snowmobiles	26,591 no	30,731 no	102.8	149.5	45.4	19.2
Golf Carts, Mopeds and Similar Vehicles	456,580 no	301,065 no	51.8	57.6	11.2	56.0
			656.9	508.3	-22.6	90.6
Capital Goods						
Nonelectric Machinery			25,333.9	28,946.8	14.3	33.2
Business Machines			17,230.9	19,626.2	13.9	36.5
Manual Office Typewriters	419,755 no	89,033 no	7,901.9	9,709.3	22.9	46.3
Electric Office Typewriters	607,664 no	640,124 no	71.2	22.4	-68.5	41.2
Calculators	16,154,418 no	11,353,085 no	144.2	133.1	-7.7	80.4
			197.9	175.2	-11.5	46.3

Commodity	Quantity		Value		Percent Change 1986/87	Japan's Share of U.S. Imports 1987
	1986	1987	86	1987		
Cash Registers (excl. point-of-sale units)					-4.9%	95.2%
Duplicating Machines	424,766 no	390,824 no	\$100.4	\$95.5	24.0	58.3
Office Copying Machines and Parts			25.8	32.0	-7.7	88.1
Copying Machines	856,654 no	727,883 no	1,283.3	1,184.0	0.2	90.5
Parts			922.6	924.4	-28.0	80.5
Microfilm and Microfiche Reader-			360.7	259.7		
Printer Combinations	102,838 no	109,707 no	129.5	152.5	17.8	78.0
Data Processing Equipment and Parts			4,703.0	6,350.4	35.0	43.0
Data Processing Equipment			2,781.1	3,490.3	25.5	49.3
Parts			1,921.9	2,860.2	48.8	37.2
Telephone Answering Machines and Office Recording and Transcribing Machines (except battery-operated)			136.0	106.1	-22.0	35.1
Machine Tools and Parts			1,272.8	1,167.7	-8.3	49.5
Electric Discharge Machines	956 no	691 no	56.1	46.7	-16.8	71.7
Numerically Controlled Lathes	3,888 no	3,183 no	228.0	233.1	2.2	82.9
Machining Centers	3,299 no	2,201 no	313.8	239.3	-23.7	78.4
Punching and Shearing Machines	1,801 no	913 no	95.5	50.2	-47.4	40.9
Parts			110.3	150.7	36.6	36.9
Casting Machines Used in Metallurgy and Parts			62.0	31.2	-49.7	31.1
Farm Tractors	69,266 no	58,979 no	314.0	255.6	-18.6	35.4
Under 40 Horsepower	52,000 no	51,760 no	238.0	218.6	-8.2	79.5
40-79 Horsepower	15,282 no	6,993 no	64.0	34.7	-45.8	12.6
Garden and Rototill Tractors	13,327 no	25,428 no	39.6	64.4	62.6	48.2
Tracklaying Tractors for Farm Use	1,971 no	2,597 no	63.0	85.9	36.3	62.1
Hydraulic Excavators and Other Excavating Machinery and Parts						
Backhoes, Shovels, Cramshells and Draglines	5,200 no	7,082 no	504.4	706.9	40.1	43.3
Parts			235.6	368.6	56.5	67.5
Front-End Loaders	5,682 no	4,143 no	127.8	221.8	73.6	30.7
Forklifts and Other Self-Propelled Work Trucks and Parts	31,264 no	31,377 no	192.0	159.5	-16.9	26.3
Conveyors, Jacks and Other Materials Handling Equipment and Parts			300.5	322.0	7.2	44.1
Conveyors (except belt type)						
Hydraulic Jacks	374,473 no	280,728 no	243.6	286.6	17.7	25.7
Parts			64.4	101.3	57.3	61.9
Textile Machinery and Parts			31.0	26.6	-14.2	25.5
Commercial Sewing Machines			53.9	48.4	-10.2	12.3
Knitting Machines and Parts			237.8	306.3	28.8	22.0
Pulp and Paper Mill Machinery and Parts			100.6	134.2	33.4	73.1
Sawmill and Other Woodworking Machinery and Parts			42.2	44.2	4.7	22.5
Printing Equipment and Parts			52.5	33.2	-36.8	7.2
Sheet-Fed Offset Printing Presses	461 no	400 no	34.8	49.6	42.5	15.4
Roll-Fed Offset Printing Presses	116 no	91 no	256.8	223.9	-12.8	23.7
Food Processing Machinery and Parts			105.0	86.3	-17.8	25.9
Machinery and Parts for Making Plastics and Rubber			73.5	44.6	-39.3	46.6
Injection Molding Machinery			33.5	27.5	-17.9	9.3
Molds for Plastics and Rubber			161.5	38.2	-38.2	30.0
Machinery and Parts for Wrapping or Packaging	1,229 no	1,587 no	99.3	132.5	33.4	49.3
Candy and Tobacco Products			29.6	75.2	154.1	22.7
Automatic Weighing Machinery						
Industrial Equipment for Treating Materials by Temperature Change and Parts			46.9	44.8	-4.5	9.6
			37.8	35.4	-6.3	59.2
			50.7	89.2	75.9	23.1

Commodity	Quantity		Value		Percent Change 1986/87	Japan's Share of U.S. Imports 1987
	1986	1987	1986	1987		
Airconditioning Machinery and Parts						
Pumps (except for motor vehicles) and Parts			\$214.7	\$244.5	13.9%	52.7%
Compressors and Parts			77.7	88.7	14.2	11.4
Refrigeration and Airconditioning Compressors			392.8	499.8	27.2	56.2
Under 1/4 Horsepower	1,546,371 no	1,405,852 no	63.5	67.5	6.3	43.0
Refrigeration and Airconditioning Compressors						
Between 1/4 and 1 Horsepower	950,309 no	954,010 no	44.8	45.8	2.2	49.0
Refrigeration and Airconditioning Compressors						
Over 1 Horsepower	3,461,733 no	4,151,649 no	206.3	293.3	42.2	91.9
Parts			57.9	77.4	33.7	43.2
Fans and Blowers (except for motor vehicles) and Parts			77.8	84.7	8.9	13.3
Power Hand Tools			217.1	217.9	13.4	44.1
Electric Hand Tools			202.8	210.0	3.6	54.7
Electric Drills			56.0	49.8	-11.1	56.4
Electric Saws	1,323,407 no	1,105,239 no	60.1	70.0	16.5	78.6
Tools for Hand or Machine Use and Accessories	847,869 no	895,202 no	173.3	220.0	26.9	23.6
Bearings and Parts			290.3	300.8	3.6	42.4
Radial Ball Bearings (unmounted)			104.9	106.6	1.6	37.0
Parts of Ball Bearings			26.9	32.4	20.4	75.0
Tapered Roller Bearings and Parts			94.4	93.6	-0.8	70.7
Taps, Cocks, Valves and Similar Devices and Parts			235.4	260.1	10.5	21.4
Speed Changers and Other Transmission Equipment			58.6	68.8	17.4	14.5
Small Stationary Diesel Engines and Parts			135.3	150.1	10.9	26.2
Small Stationary Gas Engines and Parts			227.7	321.3	41.1	70.6
Steam Turbines and Parts			47.1	27.0	-42.7	25.4
Electromedical Apparatus and Parts			206.3	226.0	9.5	31.4
X-Ray Apparatus and Parts			100.8	115.1	14.2	17.0
Medical, Dental and Veterinary Instruments and Parts			203.4	210.6	3.5	25.0
Optical Instruments (excl. electro-optical)			132.5	130.8	-1.3	73.7
Telescopes and Binoculars			103.8	76.3	-26.5	58.0
Microscopes and Parts			78.8	74.3	-5.7	43.4
Nonelectric Measuring, Checking, Analyzing and						
Controlling Instruments and Parts			154.3	177.1	14.8	22.4
Drafting and Marking Out Devices			50.1	57.9	15.6	31.4
Electric Measuring, Checking, Analyzing and						
Controlling Instruments and Parts			485.9	564.2	16.1	26.7
Instruments for Measuring or Controlling Liquids						
and Gases						
Instruments for Physical or Chemical Analysis			80.1	113.1	41.2	31.7
Instruments and Apparatus for Checking or Measuring			34.3	71.1	107.3	31.1
Electrical Quantities						
Film Processing and Printing Equipment			112.7	136.8	21.4	38.7
Magnetic Media			160.1	129.1	-19.4	63.2
Blank Audio Cassettes			863.0	810.9	-6.0	61.9
Blank Video Cassettes			71.1	89.1	25.3	48.4
Blank Audio Recording Media (excl. cassettes and cartridges)	67,536,899 no	90,792,658 no	461.4	243.8	-47.2	55.9
Blank Video Recording Media (excl. cassettes and cartridges)	142,968,638 no	73,211,991 no	60.6	69.7	15.0	54.5
Blank Computer Tape			148.0	240.8	62.7	87.1
Buildings, Door Frames and Other Structures			62.9	29.0	-53.9	41.8
of Nonferrous Metals			129.4	8.1	-93.7	4.7

Commodity	Quantity		Value	Percent Change 1986/87	Japan's Share of U.S. Imports 1987
	1986	1987	1986		
Electric Machinery			\$7,532.5	13.1%	33.8%
Semiconductors			1,275.5	34.6	23.7
Discrete Devices			347.0	7.0	30.1
Power Transistors			28.8	31.6	19.9
Transistor Parts	94,511,863 no	155,286,602 no	232.9	2.6	45.5
Integrated Circuits			928.5	44.9	22.4
Linear (Analog) Chips			47.9	16.3	8.6
Digital Bipolar Chips	54,844,925 no	72,719,436 no	126.1	1.3	10.8
Digital Metal Oxide on Silicon Chips			1,043.9	50.3	29.4
Hybrid Chips	296,194,229 no	343,446,700 no	55.0	98.4	24.6
Chips, Dice and Wafers	23,255,676 no	39,311,288 no	116.1	43.2	45.4
Mounted Piezo Electrical Crystals	90,352,210 no	97,592,585 no	46.3	39.3	63.8
Printed Circuit Boards	12,287,199 no	16,312,427 no	131.2	35.8	33.5
Capacitors			137.4	25.5	38.1
Fixed Aluminum Electrolytic Capacitors	901,358,717 no	1,149,539,674 no	57.8	31.3	81.0
Fixed Ceramic Capacitors	1,583,820,790 no	1,611,121,478 no	45.4	-3.5	26.0
Electronic Tubes and Parts (excl. television picture tubes)					
Cathode Ray Tubes			69.1	30.2	36.1
Microphones, Loudspeakers and Amplifiers and Parts			32.9	0.6	75.0
Loudspeakers			544.4	-4.0	48.1
Audiofrequency Amplifiers			245.4	-0.6	49.4
Television Cameras and Parts	40,127,085 no	43,714,154 no	182.4	-0.9	57.6
Radio Transceivers (excl. citizens' band)	2,337,589 no	1,978,963 no	383.2	-32.8	90.4
Radio Antennas (excl. citizens' band)	510,200 no	399,961 no	112.4	7.7	37.0
Radar and Radio Navigational Aids and Parts	541,781 no	575,993 no	32.5	9.5	51.7
Radiotelephonic Apparatus and Parts	3,195,677 no	3,388,683 no	91.9	13.6	39.5
Telephone Apparatus and Parts			308.8	32.3	32.3
Telephone Switching Equipment and Parts			756.7	-6.5	37.4
Telephone Instruments and Parts			162.8	-23.9	29.4
Telegraph Apparatus and Instruments and Parts			363.6	-7.0	35.0
Electrical Transformers and Parts			323.8	85.8	72.7
Switchgear			33.3	-4.2	9.9
Circuit Breakers			538.1	41.9	29.0
Switches			16.8	99.4	26.1
Relays			210.9	41.4	36.8
Connectors			48.1	38.0	17.4
Rectifiers and Rectifying Equipment			154.9	57.8	25.9
Resistors			83.7	26.6	35.9
Insulated Electrical Conductors With Fittings			73.1	30.6	16.4
Insulated Electrical Conductors Without Fittings			27.4	-21.9	7.8
Electric Motors and Generators			228.0	-1.1	27.9
Electric Motors Under 1/40 Horsepower			87.8	-1.6	52.0
AC Electric Motors Over 1/10 Horsepower					
But Less Than 1 Horsepower					
Electric Generators Under 40,000 Kilowatts					
Generator Sets					
Gasoline Engine Generators Not Over 5 Kilowatts					
Welding Equipment and Parts					
Batteries and Parts (excl. lead-acid batteries)					
Primary Cells and Primary Batteries and Parts					
Nickel-Cadmium Storage Batteries					
Permanent Magnets and Magnetic Workholders					

Commodity	Quantity		Value		Percent Change 1986/87	Japan's Share of U.S. Imports 1987
	1986	1987	1986	1987		
Electric Signalling Apparatus and Parts						
Indicator Panels and Parts						
Transport Equipment						
Civilian Aircraft Parts and Engines						
Parts for Rolling Stock						
Buoys, Beacons and Floating Structures and Parts						
					22.8%	31.7%
					39.3	59.2
					40.7	9.9
					11.3	23.6
					115.4	77.1
					25,500.0	
Consumer Goods						
Color Video Cassette Recorders					-13.4	15.4
Black-and-White Video Cassette Recorders					-39.5	88.1
Video Tape Players					-23.6	98.1
Assembled Color Television Receivers					5.5	65.8
Assembled Black-and-White Television Receivers					-52.4	16.9
Television Combinations					-34.2	19.6
Unassembled Television Receivers and Incomplete Subassemblies					-43.4	58.5
Television Picture Tubes and Parts					-24.7	26.9
Parts for Television Receivers					6.4	59.1
Converters, Preamplifiers, Amplifiers and Couplings for Cable Television					8.8	44.9
AM and AM/FM Radio Receivers (except for motor vehicles)						
Radio Receivers (except entertainment broadcast band)					18.7	49.3
Radio-Tape Recorder Combinations					0.9	40.3
Radio-Tape Player Combinations					38.0	57.4
Radio-Phonograph-Tape Recorder Combinations					-30.7	27.8
Audio Tape Players					2.0	37.7
Audio Tape Recorders and Parts					62.2	97.8
Tape Recorder and Tape Player Combinations (not incorporating radio or television receiver)					-19.7	60.0
Record Players, Phonographs, Record Changers and Turntables and Parts					-22.4	57.2
Electric Appliances and Parts						
Refrigerators and Parts					13.3	34.5
Microwave Ovens						
Electric Stoves and Ranges and Parts					-4.4	84.8
Window and Wall Airconditioners					-23.8	21.2
Home Sewing Machines					-9.9	17.2
Kerosene Heaters					-17.8	38.7
Lawn Mowers and Parts					-41.9	33.4
Portable Typewriters					-0.3	65.7
Typewriter and Similar Ribbons					-42.4	10.2
Electric Filament Lamps (excl. sealed beams)					-8.8	14.7
Mirror Glass					-22.4	38.3
Earthen and China Tableware and Household Articles					18.1	42.7
Nonbone China Tableware					-51.5	51.6
Earthen Tableware					9.3	27.0
Table Flatware and Kitchen Knives					20.4	28.4
Metal Housewares					-8.0	27.5
Pipe Wrenches and Spanners and Parts					-7.1	30.2
Fixed Focus Still Cameras					-5.6	44.3
Variable Focus Still Cameras					-15.1	27.9
					-23.5	5.6
					-25.5	16.5
					-16.5	24.6
					4.1	88.9

Commodity	Quantity		Value		Percent Change 1986/87	Japan's Share of U.S. Imports 1987
	1986	1987	1986	1987		
Still Camera Parts			\$34.0	\$30.0	-11.8%	44.8%
Mounted Photographic Lenses			194.5	194.9	0.2	82.8
Flash Apparatus			54.5	54.1	-0.7	63.0
Still Photographic Color Film (35 mm)			54.3	70.6	30.0	60.1
Optical Elements			129.8	142.0	9.4	43.9
Glasses and Frames			86.0	91.9	6.9	13.1
Frames			58.6	64.5	10.1	18.7
Clocks and Watches and Parts			472.9	518.4	9.6	30.8
Solid State Electronic Watches			48.9	78.2	59.9	35.7
Other Watches Without Balance Wheel and Hairspring			303.5	335.4	10.5	39.5
Electric Clocks (incl. battery operated)			42.3	28.6	-32.4	33.3
Toys and Sporting Goods			523.1	749.4	43.3	13.6
Toys			134.8	58.5	-56.7	2.4
Rubber or Plastic Toys			17.3	17.3	-78.8	4.3
Models			44.5	64.8	45.6	23.7
Video Games and Parts			129.7	398.4	207.2	59.2
Firearms and Parts			62.2	15.2	15.2	27.0
Fishing Equipment			79.2	86.6	9.3	31.3
Golf Equipment			28.9	43.1	49.1	22.6
Musical Instruments and Parts			391.0	542.9	38.8	60.9
Pianos and Parts			67.2	85.1	26.6	49.6
Electronic Musical Instruments			245.1	377.7	54.1	89.2
Motorcycles and Parts (excl. engines)			853.3	553.3	-35.2	88.1
Motorcycles			691.6	392.9	-43.2	89.9
Motorcycles with Piston Displacement Between 190 cc and 290 cc			140.2	75.1	-46.4	94.7
Motorcycles with Piston Displacement Over 290 cc			410.3	223.3	-45.6	87.7
Parts (excl. engines)			161.7	160.3	-0.9	84.1
Adult Bicycles and Parts			155.2	130.0	-16.2	24.9
Bicycles			68.4	48.5	-29.1	13.9
Parts			86.8	81.5	-6.1	45.7
Outboard Motors and Parts			183.5	217.9	18.7	79.1
Parts for Pleasure Boats			36.6	75.0	104.9	41.3
Clothing and Accessories			464.0	379.4	-18.2	1.9
Women's Cotton Slacks			59.6	45.6	-23.5	6.2
Women's and Girls' Cotton and Manmade-Fiber Knit Shirts			25.9	18.5	-28.6	1.7
Scarves, Shawls and Mufflers			42.9	52.5	22.4	36.3
Furniture			75.5	54.6	-27.7	1.4
Pearls (not set or strung)			161.5	128.2	-20.6	82.3
Jewelry			74.4	61.4	-17.5	2.3
Works of Art			45.4	33.0	-27.3	3.8
Printed Material			197.0	207.3	5.2	13.9
Books			125.7	126.8	0.9	17.6
Pens and Pencils			129.3	125.2	-3.2	49.7
Ballpoint Pens			50.5	60.3	19.4	57.8
Marking Pens			31.7	24.7	-22.1	47.4
Cigarette Lighters and Parts			25.9	20.9	-19.3	23.9
Pharmaceuticals			261.0	330.9	26.8	12.5
Bulk Vitamins			50.9	53.1	4.3	30.7
Bulk Antibiotics			42.5	50.0	17.6	17.9
Benzeneoid Drugs			131.7	176.9	34.3	14.4
			223,740,442 no	268,638,281 no		

Japan's Share
of U.S. Imports
1987

Percent
Change
1986/87

Value
1986 1987

Quantity
1986 1987

Commodity

Commodity	1986	1987	1986	1987	Percent Change 1986/87	Japan's Share of U.S. Imports 1987
Intermediate Goods					4.8%	5.6%
Steel Mill Products					-0.8	26.1
Ingots, Blooms, Billets and Slabs (excl. alloyed)	4,422,244 stn	4,321,042 stn	\$6,948.7	\$7,281.0	-0.8	4.7
Wire Rods and Bars	155,266 stn	91,305 stn	2,231.5	2,214.7	-25.7	22.8
Unalloyed Wire Rods	841,812 stn	1,014,997 stn	27.2	20.2	13.9	19.8
Alloyed Wire Rods	216,685 stn	202,340 stn	345.7	393.8	-6.1	35.6
Alloyed Bars	54,464 stn	50,145 stn	41.1	37.4	-9.0	32.9
Semifinished Angles, Shapes and Sections Over 3"	40,577 stn	42,060 stn	43.4	42.6	-1.8	32.9
Plates and Sheets	408,494 stn	589,938 stn	129.7	183.3	41.3	31.7
Tin Plate and Tin-Coated Sheets	2,535,358 stn	2,310,248 stn	1,209.6	1,287.7	6.5	41.9
Coated Plates and Sheets	1,237,906 stn	1,371,329 stn	113.0	82.8	-26.7	49.6
Unalloyed Non-Pickled Plates and Pickled Sheets	1,237,330 stn	1,371,329 stn	628.5	735.0	16.9	10.4
Black Plate	211,684 stn	216,953 stn	67.0	75.9	13.3	71.3
Unalloyed Hot-Rolled Sheets	139,295 stn	113,358 stn	56.9	51.4	-9.7	6.9
Unalloyed Cold-Rolled Sheets	104,393 stn	80,630 stn	31.5	25.4	-19.4	25.1
Alloyed Plates and Sheets	527,367 stn	472,783 stn	208.4	207.2	-0.6	31.4
Strip	95,769 stn	97,599 stn	94.5	98.5	4.2	26.3
Alloy Tool Steel Strip	50,981 stn	40,410 stn	62.7	54.5	-13.1	45.0
Rails	18,201 stn	9,959 stn	30.8	21.5	-30.2	46.1
Wire (excl. flat wire and insulated electric wire)	88,661 stn	81,260 stn	34.3	30.5	-11.1	18.9
Unalloyed and Uncoated Wire	107,502 stn	97,617 stn	80.3	70.7	-12.0	19.3
Tubes, Pipes and Fittings	74,946 stn	43,161 stn	47.6	24.6	-48.3	23.3
Cast Fittings, Forged Steel Flanges and Butt-Weld Fittings	717,304 stn	559,940 stn	464.4	350.6	-24.5	23.7
Unalloyed Welded or Seamless API Line Pipe	25,703 stn	12,405 stn	51.8	32.8	-36.7	17.2
Unalloyed Welded or Seamless Pipes and Tubes, Threaded	178,563 stn	70,724 stn	73.9	29.5	-60.1	67.2
Unalloyed Pipes and Tubes of Circular Cross Section	83,430 stn	68,868 stn	53.7	43.5	-19.0	42.7
Alloyed Pipes and Tubes	102,700 stn	125,136 stn	55.7	65.2	17.1	27.0
Nonferrous Metals	46,948 stn	27,674 stn	74.3	49.6	-33.2	5.6
Copper and Copper Alloys			504.6	450.6	-10.7	9.2
Pipes and Tubes			121.0	142.9	18.1	40.2
Aluminum and Aluminum Alloys			71.4	78.5	9.9	8.5
Wrought Aluminum Sheets and Strip, Not Clad	152,351 stn	104,239 stn	330.3	242.3	-26.6	33.7
Steel Pillars, Girders and Similar Structural Units			294.1	203.3	-30.9	10.0
Wire Products (excl. insulated electric wire)			27.8	15.0	-46.0	22.7
Steel Wire Strand, Unfitted and Uncovered	41,165 stn	44,535 stn	131.3	124.5	-5.2	29.7
Brass-Plated Steel Rope and Cable, Unfitted and Uncovered	21,190 stn	14,237 stn	46.3	57.9	25.1	34.5
Nails and Industrial Fasteners	48,092 stn	35,184 stn	45.2	32.1	-29.0	30.1
Steel Bolts and Bolts With Nuts	45,757 stn	42,891 stn	384.4	390.4	1.6	31.7
Steel Nuts	136,363 stn	120,503 stn	80.5	90.5	-6.7	44.1
Steel Screws			172.4	169.7	-1.6	44.1
Locks and Padlocks			30.2	50.7	67.9	19.2
Steel Chains			68.5	62.8	-8.3	40.0
Industrial Chemicals (excl. fertilizers and pharmaceuticals)			1,359.7	1,618.7	19.0	20.1
Organic Chemicals Found Naturally in Coal Tar			54.0	47.7	-11.7	11.5
Benzene	31,340,791 gal	20,950,218 gal	26.4	26.6	0.8	13.3
Other Cyclic Organic Chemical Products			139.0	169.7	22.1	15.2
Aromatic or Odoriferous Compounds (incl. flavors)			65.1	53.6	-17.7	55.1
Organic Acids, Acid Anhydrides and Salts			127.3	86.3	-32.2	23.9
Amino Acids and Other Nitrogenous Compounds			142.5	187.5	31.6	14.5

Commodity	Quantity		Value		Percent Change 1986/87	Japan's Share of U.S. Imports, 1987
	1986	1987	1986	1987		
Iodine	2,147 stn	2,753 stn	\$24.7	\$38.4	55.5%	79.9%
Synthetic Organic Dyestuffs			155.2	199.3		46.7
Plastic Materials and Resins			344.0	397.8	15.6	22.4
Flexible Film, Strips and Sheets of Plastic Materials			156.7	185.9	18.6	27.9
Synthetic Rubber			33.0	41.3	25.2	11.6
Rubber or Plastic Hose, Pipe and Tubing			62.2	72.6	16.7	29.8
Rubber or Plastic Machinery Belts and Belting			28.2	33.6	19.1	23.4
Rubber or Plastic Gaskets			49.9	61.9	24.0	24.0
Tires and Tubes (excl. car, truck and bus tires)			100.8	104.9	4.1	28.3
Plywood and Veneers	117,208 msf	105,319 msf	137.3	177.2	-30.3	2.4
Paper Products			91.6	122.2	29.1	2.5
Coated Paper and Paperboard			61.5	75.5	33.4	13.9
Yarns, Fabrics and Made-Up Textile Articles			163.5	149.9	-8.3	11.6
Manmade-Fiber Yarn	11,944 stn	11,286 stn	357.1	285.8	-20.0	32.1
Cotton Fabrics	117,690,865 syd	90,107,072 syd	211.0	170.4	-19.2	48.7
Manmade-Fiber Fabrics	304,217,489 syd	217,381,016 syd	27.4	29.6	8.0	12.9
Fabrics 85 Percent or More By Weight Polyester	186,794,941 syd	138,349,886 syd	27.1	29.8	10.0	14.8
Silk Fabrics	5,189,809 syd	4,960,861 syd	37.5	38.5	2.7	36.7
Wool Fabrics	5,156,937 syd	5,463,026 syd	59.9	54.7	-8.7	14.4
Wadding, Battling and Nonwoven Fabrics	1,594 stn	1,760 stn	53.1	38.6	-27.3	34.7
Ceramic Tile	54,556,963 sft	41,951,285 sft	23.0	34.5	50.0	62.8
Electrodes for Electric Furnaces and Electrolytic Use	30,224 stn	26,574 stn	358.3	384.2	7.2	42.0
Coke for Use as Fuel	294,103 stn	540,842 stn	55.2	50.0	-9.4	44.4
Photographic Film and Paper (excl. film packaged for retail sale)	76,429,306 sft	65,397,991 sft	131.0	123.5	-5.7	43.1
Medical X-Ray Film	682,674,112 sft	613,622,249 sft				
Silver Halide Color Photographic Paper						
Food and Feed			503.9	450.8	-10.5	1.9
Fish and Fish Products			260.1	223.7	-14.0	4.0
Scallops			50.4	38.4	-23.8	23.6
Alcoholic Beverages	5,822 stn	4,207 stn	31.3	33.6	7.3	1.0
Miscellaneous Imports			824.4	817.1	-0.9	6.8
U.S. Goods Returned			369.7	350.3	-5.2	5.3
Estimated Shipments			389.2	406.3	4.4	17.4

Key to quantity abbreviations:

gal = gallons
msf = thousand square feet
no = number
pc = pieces
sft = square feet
stn = short tons
syd = square yards

*Imports are valued on a Customs value basis.

7/27/88

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J A P A N · E C O N O M I C · I N S T I T U T E

J E I

R E P O R T

A Two-Part Report: A and B

NO. 27B
July 15, 1988

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Congressional Panel Critical Of Japan's Economic Policies

The Joint Economic Committee of Congress earlier this year gave it to the Reagan administration with both barrels for its handling of the economy. More recently, a report on West Germany criticized Germany's macroeconomic stance. So it came as no surprise that the committee's report on Japan would be sharply critical of Tokyo's policies.

The Reagan administration, while aiming to improve access for U.S. exporters to Japanese markets, has supported Japan's moves since early 1987 to expand its economy. Washington and Tokyo also have acted largely in concert since the Plaza Accord of September 1985 to support higher values of the yen.

percent real rise in GNP by itself would lead to only a 2 percent real expansion in imports from the United States. The increases from other countries, particularly the newly industrialized economies, are predicted to be far greater.

In the introduction to the committee's work, Sen. Paul Sarbanes (D, Md.) notes that the report is not intended to minimize the policy changes Washington needs to make to reduce the enormous U.S. current account deficit. Few, least of all Japanese policymakers, would disagree. The committee itself noted in a previous study that large federal budget deficits have reduced U.S. fixed non-residential investment, a critical component of increased export or import-substitution capacity in the United States. That same red ink has also induced an inflow of Japanese and other foreign capital, which in turn has propped up the dollar and contributed to the persistence of trade imbalances.

Douglas Ostrom

Rising Yen Holding Down Japanese Prices

For years Japan was accused of deliberately preventing the yen from rising. The depressed currency kept exports healthy and imports low. Since the yen started soaring in 1985, however, the advantages of a high yen have become more apparent.

One of the positive attributes of a strong yen that Japan worries it would lose if its currency weakened is price stability. As the yen has risen, exporters to Japan have been able to lower their prices in yen while maintaining or even increasing profit margins in their own currency. Since Japanese distributors have not increased their margins dramatically, and have often reduced them, the result has been lower prices for consumers and industrial buyers (see JEI Report No. 25B, July 1, 1988).

But the benefits do not stop there. Domestic import-competing industries have to shave their prices in the face of increasing competition. If they are exporters, they face problems raising their prices in dollars because of competition overseas. If they cannot raise dollar prices to offset the yen's appreciation, yen-based export prices fall. Some of this may spill over into the prices charged domestic customers for export goods, partly because exporters may divert some production to the home market. The result should be three-sided price stability: of imports, import-competing goods and export goods sold domestically.

While far from conclusive, the Table suggests that at least some of these effects may have been present in recent years. Of course, many factors besides exchange rates influence price levels. However, as the yen has increased in value, import prices have fallen almost in lockstep, and declines in domestic prices, while smaller, have followed a similar pattern. The relationship is also evident in quarterly data.

The effect of falling import prices on domestic price levels may be increasing. The Bank of Japan has compared the recent period with an earlier interval when the currency was strong. For the same 40 goods in which foreign

suppliers and domestic producers competed, it found that the domestic goods declined in price 46 percent as much as imports between September 1985 and February 1988, while between December 1976 and October 1978 they averaged less than 40 percent of the decline in import prices. The bank concludes that competition between domestic and imported goods is becoming more intense.

Effect of Yen Appreciation on Prices

(1985 = 100)

	<u>Yen/\$ Exchange Rate</u>	<u>Import Prices</u>	<u>Domestic Wholesale Prices</u>
1981	92.6	106.7	100.9
1982	104.6	115.1	101.4
1983	99.8	106.1	100.7
1984	99.8	102.5	100.8
1985	100.0	100.0	100.0
1986	70.6	64.2	95.3
1987	60.7	58.9	92.3

Source: Bank of Japan

For American producers, these changes, if they persist, are mostly good news. A strong yen will carry some weight, both to push import prices lower for Japanese buyers and to force import-competing Japanese firms into price reductions. In the longer run, Japanese exporters will find their domestic markets much less of a safe haven; attempts to maintain prices at home will be challenged by other exporters or even by importers. The resultant price stability will benefit Japanese consumers. Even many exporters will benefit to the extent that lower production costs at home offset some of the pain of the high yen in foreign markets.

Douglas Ostrom

Stock Affair Complicates Tax Reform's Chances

Embarrassingly profitable stock transactions may raise another political obstacle Prime Minister Noboru Takeshita must overcome before a sweeping tax reform plan can be enacted. Opposition parties are grasping at every straw in an effort to prevent passage of a 3 percent general consumption tax; they will surely try to turn the stock affair into a major confidence issue.

Personal aides to several political figures -- including Mr. Takeshita; Yasuhiro Nakasone, the previous prime minister; Kiichi Miyazawa, the finance minister, and Shintaro Abe, the secretary general of the Liberal Democratic Party -- and several private businessmen are said to have made unusually high profits from the sale of Recruit Cosmos Co., Ltd. shares. The shares initially were sold for ¥1,200 each (\$9.60 at ¥125=\$1.00) to 76 people, including the personal aides, when the company was strapped for cash in 1984. When the real estate firm went public two years later, the aides and others sold their shares

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J A P A N · E C O N O M I C · I N S T I T U T E

J E I

R E P O R T

A Two-Part Report: A and B

NO. 28B
July 22, 1988

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Japan's Savings Rate Holds Steady

Japan has a well-known reputation for thrift -- its savings rate is among the world's highest. But this apparently laudable trait has come in for criticism in recent years, being blamed for, among other ills, Japan's stubborn current account surplus. Now, however, reports of a consumer boom that has involved, among other extravagances, gold-flaked soap and food indicate Japan's excessive savings may be a diminishing problem. This argument suggests that, if only the Americans -- old hands at consumer profligacy -- would do their part by restraining themselves a little, the bilateral balance and other sources of trade friction would become much less irritating.

Unfortunately for this scenario, neither side seems to be playing its appointed role. The latest Organization for Economic Cooperation and Development data show that the gap in household savings rates actually widened last year as the miniscule U.S. rate dropped further while the Japanese rate was unchanged. Over a longer period of time, the OECD data indicate a downward trend in the United States, Japan and Europe. Increasing emphasis on savings in economic policymaking has so far failed to even slow down that trend (see Table).

Net Household Savings

(percentage of disposable household income)

<u>Year</u>	<u>Japan</u>	<u>United States</u>	<u>European Community</u>	<u>Total OECD</u>
1977	21.8%	9.4%	15.0%	14.0%
1978	20.8	7.3	15.9	12.5
1979	18.2	7.0	15.9	11.9
1980	17.9	7.3	16.0	12.0
1981	18.3	7.7	16.1	12.3
1982	16.5	7.0	15.7	11.8
1983	16.3	5.5	14.5	10.6
1984	16.0	6.3	14.6	10.8
1985	16.0	4.6	14.4	10.0
1986	16.6	4.5	14.3	9.8
1987	16.6	3.9	13.5	9.3

Source: Organization for Economic Cooperation and Development

The data in the table give only a partial picture of a nation's savings rate; other elements necessary to interpret the picture include awareness of several problems:

- The accuracy of the figures is open to question. Roughly speaking, the savings rate is defined as what is not spent as a percentage of what is not taken out by taxes from household income. Small errors in the underlying data can skew this percentage, a ratio of two residuals.

- Savings are counted as what is not consumed, raising the hard question of determining when the consumption occurs. A connoisseur stocking a wine cellar is saving because he is diverting some of his current income into consumption years away. As a practical matter there is often no way to segregate what is purchased for current use (appropriately counted as consumption) from that which is purchased for later use (which ideally should be included in savings). Kenichi Ohmae of McKinsey and Co. notes that resale markets are more common in the United States than Japan; for example, the ability of Americans to cash in on the residual value of even their used clothing suggests a savings dimension to many consumer expenditures in the United States. Yet economic statistics assume wine, clothing and many other items are completely consumed shortly after purchase. If, as experts generally agree, mislabeling of savings as consumption is more common in the United States than Japan, then the table overstates the differences. By one estimate this effect alone explains about one-third of the gap shown between the two countries' savings rates (see JEI Report No. 17A, May 1 1987).

- The generally reported data refer to household savings, which, while important, are not the whole story. Firms and governments also save, and international capital flows can augment or reduce the supply of savings available for use domestically. Even in Japan, households contribute less than half the supply of gross savings to the capital markets. In contrast to households,

governments and firms use more capital than they supply in both Japan and the United States, but if net government dissaving could be reduced, for example, the pressure on household savings would decrease. In Japan the foreign sector is a heavy user of funds (reflecting Japan's current account surplus and corresponding capital outflows), while in the United States the foreign sector supplements the household sector as a net supplier.

• The intended use of savings is critical to assessing the importance of low savings rates in American households, as the wine cellar example suggests. Wine contributes little of value until drunk, if then. By contrast, savings used to finance a steel mill can increase the productive capacity of the economy over a period of many years.

As the effort to reduce the Japanese savings rate implies, higher rates are not always better. A lower average savings rate corresponds to a higher rate of consumer spending and an overall stimulus to the economy, which is welcome if there is room for expansion without creating inflation. In other situations, however, a lower savings rate implies that more of the economy's current output is being used up in the current period, which, other factors being equal, leaves less for investment that adds to future productivity.

In short, the debate over savings will go on. In part, it will be over measurement, with some like Mr. Ohmae rejecting even the idea that Japan saves more than the United States. Others will debate appropriate savings levels and how to achieve the desired results.

Douglas Ostrom

OTA Issues Warning On U.S. Trade Deficit

Sometime, perhaps soon, the United States will have to pay the bill it's been running up with international creditors. When that time comes, the current account deficit will have to be reduced. The main hope for substantial change in that balance is improved competitiveness in manufacturing, in which imports are concentrated and where export expansion is most promising. Reversing the recent trend of declining competitiveness is one of the challenges facing U.S. industry and, if the bill is to be paid, American policymakers.

That, in broad outline, is the message that the Office of Technology Assessment has delivered to Congress in Paying the Bill: Manufacturing and America's Trade Deficit. OTA, an analytical arm of Congress that usually specializes in technical issues, cannot make policy recommendations, but the implications are pretty clear: changes are needed in the way manufacturing is approached in this country. Japan, of course, is one of America's largest creditors and, not coincidentally, one of its chief rivals, especially in the development and deployment of advanced technology. OTA acknowledges this fact in the numerous examples it gives of superior Japanese manufacturing practices.

The key question is how U.S. manufacturers are going to get back their lost advantages. OTA sees long-term structural problems at the firm and industry level -- factors that transcend business cycles and exchange rate policies -- as important causes of the trade imbalances. While less focused on the firm

legislation aimed primarily at continued inquiry into fundamental, rather than Band-Aid, solutions to chronic bilateral trade frictions.

Participants agreed to use the "bilateral forum" approach to examine the two countries' patent systems; their goal is to complete their recommendations in time for an October meeting of American, Japanese and European officials. Tokyo's patent system has recently come under fire due largely to highly vocal complaints from some U.S. high technology firms of patent infringement by Japanese companies (see JEI Report No. 25B, July 1, 1988).

The conference participants also agreed to:

- Develop joint U.S.-Japan recommendations for the Uruguay Round of multilateral trade negotiations under the General Agreement on Tariffs and Trade. The recommendations are expected to cover negotiations on GATT reform, safeguards, intellectual property rights, investment and services.

- Recognize the usefulness of multilateral, bilateral and regional trade arrangements, provided that these initiatives are consistent with and supportive of the GATT and the Uruguay Round.

- Review the current Cocom (Coordinating Committee for Multilateral Export Controls) export control system to examine ways to limit the coverage to truly significant products and technologies as well as consider how to include non-Cocom countries in a multilateral control system.

- Approve a statement urging U.S. and Japanese industries to work toward an international agreement on government regulations of biotechnology and its products.

- Endorse a statement that free and unencumbered investment is in the best interests of the United States and Japan and that sectoral or security considerations should not be allowed to distort the free entrance and operation of foreign investment.

Prime Minister Noboru Takeshita encouraged the conference to continue its work to contribute to a healthier bilateral relationship. The group also received high marks in Washington. Remaining to be seen is whether or not and to what extent the group's recommendations will be pursued in the national legislatures and/or through executive actions.

Barbara Wanner

Notes

Rice - With a fifth consecutive bumper crop of rice expected in Japan this fall and rice consumption continuing to decline, agriculture and finance ministry policymakers increasingly worry that the government could be saddled with another expensive rice disposal program. Inventories are projected at 2.3 million metric tons by the time the 1988 crop is harvested -- well above the 1.5 million metric ton figure that Tokyo considers the upper limit for adequate stocks. This projection has persuaded Prime Minister Noboru Takeshita's cabinet

to trim the price at which the government buys rice from farmers for the second year in a row. The 4.6 percent cut in the support price for 1988 crop rice, approved July 8, will drop the producer price 10.3 percent below its 1984-86 level (see Table).

Rice Support Prices, 1980-88

(per 60 kilograms)

<u>Crop Year*</u>	<u>Purchase Price</u>		<u>Selling Price</u>	
	<u>Amount</u>	<u>Change</u>	<u>Amount</u>	<u>Change</u>
1980	¥17,674	2.3%	¥15,891	n.a.%
1981	17,756	0.5	16,391	3.1
1982	17,951	1.1	17,033	3.9
1983	18,266	1.8	17,033	0.0
1984	18,668	2.2	17,673	3.8
1985	18,668	0.0	18,327	5.8
1986	18,668	0.0	18,598	1.5
1987	17,557	-6.0	18,133	-2.5
1988	16,743	-4.6	n.a.	n.a.

*From November of indicated year through October of following year.

While the decision to lower the purchase price lacked the drama of the government's ultimately futile 1986 attempt to tackle the primary cause of chronic overproduction (see JEI Report No. 44A, November 20, 1987), the move ironically generated more controversy than last year's vote to cut the politically sacred support price for the first time in 31 years. The Ministry of Finance had pushed for a reduction of at least 5 percent. The Ministry of Agriculture, Forestry and Fisheries had no objection to a decrease of this size, but members of the Liberal Democratic Party's farm lobby -- who account for 200 of the Diet seats held by the ruling party, according to one count -- did. What really troubled them, however, was the government's plan to change the formula for determining support prices and to restrict subsidies to farmers who cultivate more than 1.5 hectares (3.7 acres) of paddy fields.

The proposed pricing computation, worked out by the Rice Price Council, a MAFF advisory group, in an attempt to improve the efficiency of Japan's agriculture sector as well as prevent a rice inventory buildup, would base purchase prices for the time being on the costs of production of farmers with a minimum of 1.5 hectares of paddy field; eventually, 5-hectare (12.4-acre) farms would be the standard. (Only 9 percent of Japanese farm households have more than 1.5 hectares of rice, MAFF calculates, but they account for 44 percent of output.) By one estimate this formula would cut support prices by an extra 13 percent over the next three years -- an unacceptable number for many LDP politicians. In the end, the government and the party compromised. The reduction in this year's producer price was curtailed and the cabinet put a one-year hold on the plan to both revise the pricing formula and limit subsidies to the most efficient producers.

With the decision to lower support prices now behind it, the government will undoubtedly try to offset the potential political fallout on the LDP by again shaving the price at which it resells rice to wholesalers. Like last year, this reduction, which determines the price paid by consumers, is likely to be smaller than the drop in the purchase price in order to limit the government's budget exposure. But even though wholesale rice prices will remain above support prices for a second year, Tokyo's outlays for the rice program could go up since it is expected to buy more rice from farmers than it resells.

Agriculture Import Quotas - Washington and Tokyo have reached agreement on the outlines of a timetable for liberalizing eight of the 10 agricultural import quota categories that the General Agreement on Tariffs and Trade said violated international trade rules (see JEI Report No. 47B, December 11, 1987, and No. 7B, February 1, 1988). By April 1, 1990 -- a year before the quantitative restrictions on beef and orange imports are scheduled to be lifted, the Japanese government will eliminate the quotas on processed cheese, prepared beef products, sugars and syrups, fruit purees and pastes, canned pineapple and fruit pulp, tomato juice and non-citrus fruit juices, ketchup and tomato sauce, and a miscellaneous group of processed foods. Trade in some restricted milk products will also be freed by that time and tariffs on them cut to compensate the United States for Japan's delay in removing the overall quota on milk and cream products. The schedule for decontrolling the tenth quota group -- starches and insulin -- remains a sticking point, however.

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The views expressed in this report are those of the authors and do not necessarily represent those of the Japan Economic Institute.

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J A P A N · E C O N O M I C · I N S T I T U T E

JEI

R E P O R T

A Two-Part Report: A and B

NO. 29A

July 29, 1988

UPDATE ON JAPAN'S VENTURE CAPITAL INDUSTRY: PROBLEMS AND PROMISES

Summary

Japan's venture capital industry has endured a depression since JEI's first report on this subject (JEI Report No. 39A, October 12, 1984) but is now on its way to recovery. The path out of the doldrums, however, has taken unexpected directions that mirror developments in the U.S. venture capital industry in some respects. Regulatory and cultural problems will continue to hamper venture capitalists and entrepreneurs in the Japanese market where they may never play the role they have in the United States. Nonetheless, venture capital is beginning to carve out a place for itself in Japan's economic framework, particularly in light of the nation's efforts to restructure.

Boom and Bust

By the early 1980s Japan's venture capitalists and entrepreneurs were poised for a take-off. Following the abortive "boom" of the early 1970s, the field had lain dormant. Under the impact of the computerization of Japanese businesses and homes and the development of new industries, such as biotechnology and structural ceramics, venture capitalists and entrepreneurs caught a wave of public interest in high technology industries between 1982 and 1985. Instead of a smooth ride to growth and profits, however, investors and businesses were battered about as the wave collapsed and reality set in.

The focus on high technology fields was a natural attempt to replicate the success of the U.S. venture capital industry. Many important American computer and software companies were born thanks to venture funds, and the two industries seem to be continually revitalized by innovative start-up firms.

Computer hardware and software firms, in particular, mushroomed in Japan between 1982 and 1985 in response to the growing demand from businesses and households. The boom also encompassed robotics, semiconductor manufacturing equipment, biotechnology, fiber optics and digital communications. These small firms initially were a success: they were more innovative than big companies, could produce custom products quickly and could respond to market changes with relative ease.

In spite of the continual deregulation and liberalization of Japan's domestic goods and financial markets, the long-term odds remained heavily stacked against start-up companies and their backers. Some of the factors derive from the strengths that big, established firms can bring to bear against competitors. Others arise from the structure and organization of the Japanese economy and society.

Research and development outlays - Investment in R&D is the lifeblood of high technology firms and is an area of sharp differences between small and large firms. Even if start-ups devote a very large share of their budget to new product development, the absolute amount is always dwarfed by the R&D budgets of the biggest Japanese companies. While big companies' inability to conduct research in all areas at once leaves windows of opportunity for small firms to develop niches, the cost of developing new technology in certain key areas is growing so high that only large firms have the financial resources to compete.

Manufacturing expertise and infrastructure - Established firms have in place the manufacturing facilities, in-house expertise and network of subcontractors that are often important advantages in Japan's highly competitive markets. Beyond this, however, there is an even bigger advantage for large, established firms and a barrier for start-ups. American markets with a strong venture capital component are often horizontally organized (firms produce basic, intermediate or final goods but rarely all three). In contrast, Japanese markets are generally centered around a relatively small number of large, vertically integrated companies. Matsushita Electric Industrial Co., Ltd., for example, produces a full range of electric and electronic components as well as the final products that incorporate them. Not only does this make them tougher competitors, but it often concentrates state-of-the-art manufacturing facilities in their hands. In the United States a small start-up venture can contract with a top-flight manufacturer to produce its innovative goods, but a Japanese entrepreneur cannot or will not contract out such work, since the only available contractor is often his largest competitor. The same problem exists when a firm is trying to buy leading-edge components or equipment -- the only source is often the biggest competitor. Even in American markets that are dominated by large firms, such as the pharmaceutical industry, the more fluid U.S. labor market allows start-ups to hire away first-class researchers and manufacturing workers. A capable manufacturing base can be quickly assembled, meaning this kind of barrier to market entry is lower in the United States than in Japan.

Distribution/service network - In Japan it is not always true that if you build a better mousetrap the world will beat a path to your door. Distributing your product around the country and getting space on merchants' shelves

is a labyrinthine exercise in Japan, and one that favors firms with established brand names and personal contacts. After-sales service, a critically important factor in areas like computers and other advanced machinery, is another major challenge for small firms. It takes a great deal of time and money to set up a distribution/service network, two commodities venture businesses usually have in short supply.

Access to financing - Even though the over-the-counter market was liberalized and modernized in 1984 to bring it up to par with its U.S. counterpart, it is still an ugly duckling in the eyes of most investors (see Table 1). Taking a company public, therefore, remains a difficult way for backers and entrepreneurs to recoup their investment. Since this is a major incentive for venture capitalists, the restrictive attitudes keep a lid on the market's growth.

Table 1: Initial Public Offerings in Japan, 1980-88

(in number of cases)

	<u>1980</u>	<u>1981</u>	<u>1982</u>	<u>1983</u>	<u>1984</u>	<u>1985</u>	<u>1986</u>	<u>1987</u>	<u>1988*</u>
Stock Exchange	11	22	22	26	19	26	36	45	60
Over-the-Counter	14	4	6	6	10	15	22	19	40
Total	25	26	28	32	29	41	58	64	100

*Estimated

Source: Venture Japan

Labor - The task of finding skilled management and labor willing to participate in a start-up is as difficult as ever. Although it is showing some signs of erosion, the lifetime employment system followed by large firms means that the most talented labor is often unavailable to start-ups.

The upshot of all these factors was that business became increasingly difficult for many start-ups in the mid-1980s. The archetypal case is Sord Computers Co., Ltd. After being heralded as the Apple Computer Inc. of Japan, the company came close to bankruptcy before being bailed out by Toshiba Corp. The heaviest casualties were in computer hardware, robotics and semiconductor manufacturing equipment, all fields where capital intensity favors large firms.

If venture businesses fail, investors naturally must share in the pain. But the problems start long before then since investors have to contend with poor showings in initial public offerings. The trading "themes" that sweep Japanese markets played havoc with carefully prepared IPOs. Since an IPO can take several months to prepare while a "theme" can sweep the market within a day and usually lasts less than two weeks, it is easy to see the difficulties involved in gauging the public response to a small company's first offering. Although hard data are scarce, most Japanese venture capital firms will admit that they suffered losses in the 1985-87 period. Japan Finance Co., Ltd., for example, reported that 25 of its investments in the computer and other high technology fields went belly up in 1985.

The Climb Back

Chastened but undaunted, the Japanese venture capital industry is beginning to climb out of its recession. The flood of household savings and corporate profits that has made Japan into a major financial center seemingly overnight has spilled over into the venture capital field. Corporate and individual investors, now more conscious than ever of the relative rates of return on their money, are including venture capital funds or the stock of start-up companies in their portfolios. Venture capital firms linked to banks or securities companies have participated in the financial industry boom and have replenished their investment pools (see Table 2). Stung by their losses in the 1985-87 period, however, venture capitalists are focusing on the service sector in search of fertile ground.

Table 2: Top Japanese Venture Capital Companies

(in billions of yen, as of March 31, 1987)

<u>Company</u>	<u>Founded</u>	<u>Major Stockholder</u>	<u>Total Invested</u>
Japan Associated Finance Co., Ltd.	1973	Nomura Securities Co., Ltd.	Y66.1
Nippon Investment Finance Co., Ltd.	1982	Daiwa Securities Co., Ltd.	19.2
Tokyo Small Business Development Co., Ltd.	1963	Semi-public	16.6
Osaka Small Business Development Co., Ltd.	1963	Semi-public	15.5
Yamaichi Univen	1982	Yamaichi Securities Co., Ltd.	10.4
Nippon Enterprise Development Co., Ltd.	1972	Long-Term Credit Bank of Japan, Ltd.	10.2
Tokyo Venture Capital, Inc.	1974	Dai-Ichi Kangyo Bank, Ltd.	9.1
Nikko Venture Capital, Inc.	1983	Nikko Securities Co., Ltd.	9.0
Sanyo Finance Co., Ltd.	1982	Sanyo Securities Co., Ltd.	9.0
Nagoya Small Business Development Co., Ltd.	1963	Semi-public	8.9

Source: Venture Japan

According to one of Japan's major newspapers, 31.5 percent of venture capital companies surveyed put more money into service-oriented firms in 1987 than the year before. Another 33 percent indicated that the service sector presented the best investment opportunities. The relatively low capital requirements to launch a service business and the usually simple labor requirements make service firms less susceptible to the problems manufacturing companies face. The keys to success in services are creativity and innovation, not brute capital. Service firms also represent 70 to 80 percent of the firms already listed on the over-the-counter market, making it easier to gauge public sentiment since they have an established track record.

This trend toward services also reflects shifting economic conditions: Japan's new affluence, the effort to base growth on domestic demand and the

aging of society. The workaholic Japanese suddenly are turning to leisure activities with a vengeance. The success of Tokyo Disneyland, the proliferation of resorts and the surge in Japanese touring overseas all indicate a ready demand for leisure services. Personal services, such as beauty salons, pet shops and self-improvement courses, are also growing in popularity. Education remains a top priority and the growth of special schools, training courses and other educational aids (computer-aided instruction, for example) has been steady and strong. The rapid expansion of food and retailing franchises is another bright spot that is attracting interest from venture funds. Health and nursing services are also seen as growth industries as the number of senior citizens continues to grow.

The scarcity of other investment opportunities also is pushing venture capitalists toward the tertiary sector. Even though the return on these investments is rarely spectacular, service start-ups are viewed as options with clear growth potential. This does not mean that high technology investments will be abandoned altogether, but services clearly will play a larger role for at least the next several years.

Venture Capital Flows

In view of the deregulation of Japan's financial markets and the increasing Japanese presence in global finance, the growth of venture capital flows into and out of Japan would seem a natural development. Unfortunately, little progress has been made since JEI's 1984 report, particularly in terms of foreign activity in the Japanese market. Although Japanese overseas activity has increased, it remains comparatively small.

The landscape for foreign venture capital in Japan has hardly changed since 1984 with around a dozen foreign companies operating. Some have plunged in and invested directly in Japanese start-ups on an independent basis. Most, however, have taken a more passive attitude by supporting deals organized by others. The foreign firms' chief difficulty undoubtedly arises from their position outside the network of personal contacts, which are the best sources of information on new companies in Japan. Foreign venture capitalists may bring more refined analytic and management skills to the Japanese market, but they often are beaten to the deal-making punch by established Japanese rivals. The fact that foreign investors are often willing to accept more risk has not helped them quickly penetrate the Japanese market. Foreign firms will need more time to become accepted in the Japanese community. Once accepted they will more easily attract and win the business of Japan's growing group of entrepreneurs.

Japanese venture capitalists themselves are stymied by a dearth of opportunities at home and have been trying to expand overseas operations. The appreciation of the yen has accelerated this trend. According to a private survey, a cumulative total of nearly Y9 billion (\$72 million at Y125=\$1.00) in venture funds had moved out of Japan through March 31, 1987 (see Table 3). Most of the activity has been in the United States, according to that same survey, although an exact percentage was not mentioned. Overseas investments generally are handled by a Japanese subsidiary; rarely do the parent companies invest directly on their own. A major function of these overseas offices is to provide a conduit for American and Japanese firms to arrange strategic alliances and promote technology transfers. The subsidiaries are also on the lookout for new Japan-related investments in which to participate.

Table 3: Top Overseas Venture Capital Investors

(in millions of yen, as of March 31, 1987)

<u>Company</u>	<u>Major Stockholder</u>	<u>Total Invested</u>
Kangyo Kakumaru Investments	Nippon Kangyo Kakumaru Co., Ltd.	¥1,762.5
Tokyo Venture Capital, Inc.	Dai-Ichi Kangyo Bank, Ltd.	1,575.0
Yamaichi Univen	Yamaichi Securities Co., Ltd.	1,062.5
Japan Associated Finance Co., Ltd.	Nomura Securities Co., Ltd.	1,050.0
TechnoInvestment Inc.	TechnoVenture Inc.	987.5
Nippon Enterprise Development Co., Ltd.	Long-Term Credit Bank of Japan, Ltd.	875.0
Nippon Investment Finance Co., Ltd.	Daiwa Securities Co., Ltd.	575.0
Oriental Capital Co., Ltd.	Oriental Leasing Inc.; Hambrecht & Quist; Baring Brothers, Ltd.	375.0

Source: Venture Japan

Asia is attracting an increasing amount of investment attention, particularly some of the newly industrialized economies. Taiwan and Hong Kong are well suited for venture capitalists with their numerous small, innovative and flexible companies. Although South Korea and Singapore do not have the same factors going for them, Japanese venture capital firms are establishing funds and developing contacts in these countries as well. The progress of China's economic reform program is being watched carefully by investors. Although joint ventures are encouraged by Beijing, the most desired foreign partners are large, established manufacturing firms. Some tentative moves are being made to attract venture capital in light industry, but investors are extremely cautious given the difficulties previous joint ventures have encountered.

As for other parts of the world, India and Europe are areas of current interest. Japanese direct investment in Indian manufacturing facilities has increased in recent years. The concept of the entrepreneur and venture capital is well established there, creating a conducive atmosphere for Japanese investors. In Europe, the resurgence of small high technology firms is attracting renewed Japanese interest, particularly in Great Britain. Spain and Portugal also present new opportunities thanks to their membership in the European Community and their relatively low wage rates.

In general, however, Japanese venture capitalists are just beginning to test the international waters. In tried-and-true Japanese fashion, they can be expected to adopt a cautious, incremental approach to penetrating foreign markets. From a global perspective, this may be unfortunate since the United States, as the world's top debtor nation, can be expected to reduce its high-risk foreign lending. Unless Japanese investors take up the slack, global growth may suffer.

Government's Helping Hand

In 1984 Tokyo was entranced with the concept of venture capital. General concerns focused on finding sources of innovative ideas and products as the economy evolved beyond the mass-production/mass-consumption stage. Venture businesses seemed to generate a large share of the new products and services in the United States, and Tokyo clearly hoped to replicate this function in Japan. Central and local governments established venture capital funds and tried to improve the general business atmosphere for start-ups. The Ministry of Finance's financial liberalization program, while not specifically aimed at venture capital, was expected to alleviate the critical finance problems facing entrepreneurs and investors alike. The internationalization of Japan's financial and goods markets was supposed to energize the venture capital market as well.

Unfortunately, Tokyo's hopes proved too optimistic. A financial system that developed over three decades could not be overhauled in a few years. The system's bias toward lending to large corporations remained strong. While the Tokyo Stock Exchange has experienced an unprecedented boom in the past several years, the over-the-counter market has enjoyed only moderate growth. Small companies are unable to take advantage of the Euroyen and other offshore markets or the commercial paper market. In fact, small businesses have received relatively little direct benefit from the government's financial liberalization and internationalization programs.

Nevertheless, a number of government policies, mostly administered by the Ministry of International Trade and Industry, are directed specifically at high risk, high technology small businesses:

Technopolis - MITI's long-range plan to develop centers where academic and industrial researchers can pool their efforts is proceeding pretty much as planned. The program provides low-cost land, roads, utilities and other infrastructure in an attempt to attract high technology firms to cities around the country. There are 26 Technopolis centers under development with another handful in the planning stage. The program has so far been quite successful, but doubts remain about the long-term viability of all Technopolis areas.

Japan Key Technology Center - This organization's main mission is to cofund long-term private joint research and development projects involving technologies vital to future economic growth. Since its creation by MITI in October 1985, the center has selected more than 50 projects for a total investment of Y4 billion (\$32 million). Many of these projects include venture companies, but large firms also have taken advantage of the program. Foreign firms were expected to participate, but so far the response has been meager.

Technomart - This loosely structured organization was meant to function as a clearinghouse for entrepreneurs with ideas and investors with money. Since its inception in 1985, few details have been released about its operations. Its success may be assumed since funds continue to be appropriated for it.

Venture Enterprise Center - The VEC continues to act as a modest source of low-cost loans for small businesses meeting certain managerial and product-oriented requirements. Although created in 1975, the VEC began to have an impact only in the 1980s. With an emphasis on guaranteeing loans rather than actual lending, the VEC has aided more than 500 small businesses through the

end of fiscal 1987 (March 31, 1988). Although the spread between its guaranteed loan rates and regular commercial rates has narrowed, VEC loans remain attractive.

Research Core Program - This project, the only recent addition, is very similar to the Technopolis program. A total of 33 projects is currently envisioned, centering on a wide range of subjects, including energy, biotechnology and integrated communications. Many of these research cores are actually associated with existing Technopolis developments. This program is more focused than the Technopolis plan, however, because it provides specific funding for research activities, not just low-cost infrastructure. Like the Technopolis program, research cores are meant to give businesses an initial boost. Development is expected to snowball and advance under its own momentum without further government aid as other companies are attracted to the initial activities.

Government policy, therefore, remains aimed at creating environments in which venture capitalists and entrepreneurs enjoy enhanced chances for success. Direct involvement in promoting the venture capital industry is very limited, perhaps due to the realization that central guidance could snuff out the very creativity and innovation that is desired. Nevertheless, Tokyo feels that venture capital will play a key role in keeping the economy dynamic and vital.

Benchaa Kapitaru

It is clear that Japan's venture capital industry is developing in a unique fashion, contrary to nearly everyone's hopes. Given the differences between the financial, industrial and regulatory structures of the United States and Japan, this unique path is hardly surprising. Japan's venture capital industry appears to exhibit four special attributes in its current incarnation:

- The time lapse between establishment of the venture and its initial public offering is long compared to the American average of five years. Before 1970 the gestation period was as long as 15 years; Sony Corp., for example, was incorporated in 1946 but offered its first public issue in 1958. The average shrank somewhat to around 10 years for firms established in the 1970s. CSK Corp., a computer consulting firm, is typical: it was founded in 1968 and went public in 1977. Data on ventures launched this decade are still inconclusive, although it appears that the average interval may have fallen again. This phenomenon reflects the difficulty of establishing a company's reputation in Japan. Stung by the 1982-85 economic slowdown, when many IPOs by firms less than five years old failed, investors are likely to seek proof of sustainability, thus contributing to a longer average interval for ventures going public.

- Investments in start-ups are not the sole, or even main, reason for establishing a venture capital company. Since most venture capital firms are linked to a bank or a securities company, they often serve more as a means of developing new clients for the main business rather than as an end in themselves. Some bank-related companies, for example, have arranged loans worth approximately twice as much as their direct investments. This pattern has tended to blunt the aggressiveness of Japanese venture capital firms at home and abroad.

- Possibly related to this, Japanese venture capital firms seem to prefer low-risk deals in comparison with their American counterparts. Since

the clients of venture capital firms often establish more traditional business relationships with the parent bank or securities company, they must meet the minimum requirements set by the parent. This naturally forces investors to shy away from investments an American venture capitalist would not hesitate to back.

- Japanese investors' lack of involvement in the management of start-up businesses contrasts sharply to the American situation. An American venture capitalist most often actively provides whatever expertise he has to offer -- an offer gladly accepted by entrepreneurs, who would rather focus their talents on creating and innovating. In Japan it requires a dire situation before the investor will step in. This actually breeds resentment and distrust between investors and entrepreneurs, even if the entrepreneurs could benefit from the advice.

From Venture Capital to New Business

Japan's venture capital industry remains immature, despite more than a decade of development. While younger Japanese may be personally suited to venture business as it is known in the United States, the Japanese economy may not be. In its drive to become the world's most efficient mass producer of consumer and industrial goods, the Japanese economy left very little room for small, independent companies to make a significant contribution. Financial and human resources were funneled to major Japanese corporate groups; small businesses were left to play a supporting role. The economy in the 1980s is subject to new forces and is clearly in transition. In keeping with the times, the term "venture capital" is now rarely used in the Japanese press. To avoid a high technology connotation, the term "new business" has been adopted to expand the new characterization of venture capital in Japan.

Economic restructuring is the latest buzzword in Japan, referring to an effort to make domestic demand the main driving force of growth and reduce reliance on the external sector. This trend presents both opportunities and threats for venture capital. On the one hand, Japanese consumers are focusing on the quality of life and paying a good deal of attention to leisure and personal services, as mentioned previously. Most Japanese observers expect both the young and the old to demand a growing number of services, providing a ready market for many new businesses.

On the down side, restructuring is forcing many firms in mature markets to diversify into new areas, including services and high technology. Perhaps the clearest examples of this are Nippon Steel Corp. and the Japan Railways Group (the ex-Japanese National Railways). The world's largest steel maker is pursuing an aggressive diversification program to reduce dependence on its traditional business. On April 1, 1988 it established four joint ventures in the communications and information processing fields. The JR group has chosen to move into food and dry goods sales (a chain of coffee/snack shops has been opened in or near many railroad stations) in addition to communications and transportation. The entry of such giants into areas of intense new business activity is raising fears of a repeat of the problems that hit start-ups in the high technology manufacturing field.

The strong yen has proved to have a relatively small impact on venture businesses since most were not geared toward the export market. In fact, most are overjoyed at the prospect of greater domestic spending by the government

and consumers. Some have even moved boldly into the importing business in an effort to capitalize on the yen's strength. Venture investors certainly have been buoyed by the yen's strength, and interest in overseas investments is growing.

The impact of the global stock market crash last October is still being sorted out. While the Tokyo Stock Exchange index has erased the loss, the market is still edgy. The prolonged boom may yet spur a new rash of IPOs, but there is no guarantee that the reception will be any warmer than before. A scandal involving possible price fixing of new issues has just shaken the OTC market and made it an uncertain bet at best for IPOs in the near future. The OTC market may become increasingly attractive to small- and medium-size investors, however, if the TSE climbs to unaffordable heights.

The government's continued programs of financial liberalization and deregulation represent venture capital's greatest hope and problem. If tax and financial regulations were radically liberalized and changes took place in the labor market and distribution system, an American-style venture capital industry might have a chance to evolve. Since such liberalization is unlikely, however, Japan's venture capital industry must continue to find its own path and its own place in the economy and society.

For further information, contact Jon Choy.

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The views expressed in this report are those of the author and do not necessarily represent those of the Japan Economic Institute.

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J A P A N · E C O N O M I C · I N S T I T U T E

JEI

R E P O R T

A Two-Part Report: A and B

NO. 29B
July 29, 1988

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Special Diet Session Considers Tax Reform

Overruling opposition party protests, the government opened the 120th extraordinary Diet session July 19 to consider the most comprehensive tax reform proposal in decades. Major differences of opinion between the ruling Liberal Democratic Party and the opposition parties have not been resolved, and Prime Minister Noboru Takeshita has his work cut out for him if he is to win passage of his tax reform plan within the 70-day session.

The government put the final touches on the six-bill package of reforms July 18 when it became apparent that the opposition parties would persist in their attempts to delay the opening of the special session. Convening the session without the full support of the opposition parties was a rather drastic step, and the LDP was forced to compromise by setting the special session's length at 70 days rather than the desired 120 days. The opposition parties

If the government's estimate of overall GNP growth turns out to be conservative, revenues could expand by more than ¥5 trillion (\$40 billion) to more than ¥50 trillion (\$400 billion), boosted mainly by higher corporate taxes. If this optimistic outlook proves true, the government may be able to dispense entirely with new issues of deficit-financing bonds. The sale of ¥1.3 trillion (\$10.4 billion) worth of government-held Nippon Telegraph and Telephone Corp. shares will also increase revenues. Fiscal analysts, still nervous about the long-term outlook, continue to urge the government to make hard choices while it has room to maneuver.

Much work remains to be done before the FY 1989 budget is completed. Each ministry and agency will now compile a detailed budget within the general guidelines for submission to the Finance Ministry this fall. Negotiations with MOF will then continue until the cabinet submits a budget to the next regular Diet session, which normally convenes in November. With the fate of the tax reform package up in the air (see preceding article), this year's comparatively calm budget process may yet be disturbed.

Jon Choy

Japan's Trade Surplus Dips Again

Japan continues to whittle down its trade surplus, but the process is painfully slow. Last year the surplus declined for the first year since 1982. If current trends continue, it will shrink again this year but still be larger than any year before the peak year of 1986. The levels of the early 1980s, which to many seemed intolerably high at the time, now look almost like unobtainable targets over the next several years.

The figures for the April-June 1988 quarter continue a recent pattern of increasing exports that does not augur well for surplus reduction. For the third straight quarter, export volume was higher than the year before. This increase has occurred in the face of an appreciating yen that, by making exports more expensive, is supposed to reduce their volume. Major Japanese manufacturers apparently have lowered their costs and margins significantly. Strong economies abroad also have helped to offset the effect of the higher yen on the export volume.

In considering the new figures, American policymakers may take some comfort from the fact that the increase in exports has occurred mainly in trade with Asia and Europe. For example, the dollar value of exports to the European Community jumped 26.3 percent between 1987's first half and January-June of this year while in yen they were up 7.3 percent. During the same period exports to the United States dropped 9.9 percent in yen terms while increasing 5.8 percent in dollar terms. The small gain in exports combined with soaring imports reduced Japan's dollar surplus with the United States by 14.9 percent from the first six months of last year to the same period of 1988.

Overall, imports continued to be the star of the show during the second quarter, being up by every measure. On a volume basis, for example, they posted their third straight double-digit increase, up 19.4 percent. With exports rising if measured in dollars and almost flat in yen, import growth is credited with shrinking the trade surplus on a customs-clearance basis by 13.1 percent

Japan's Total Trade in Dollar Terms

(in millions of dollars)

	Exports (f.o.b.)	Change Over Year-Earlier Period	Imports (c.i.f.)	Change Over Year-Earlier Period	Trade Balance
1983	\$146,928	5.8%	\$126,393	-4.2%	\$20,534
1984	170,114	15.8	136,503	8.0	33,611
1985	175,638	3.2	129,539	-5.1	46,099
1986	209,151	19.1	126,408	-2.4	82,743
1987	229,221	9.6	149,515	18.3	79,706
1986: I	45,499	18.2	33,005	1.5	12,494
II	53,166	21.5	31,424	-2.1	21,742
III	54,768	24.7	30,153	-3.5	24,615
IV	55,718	12.6	31,826	-5.5	23,892
1987: I	51,464	13.1	31,977	-3.1	19,487
II	56,931	7.1	36,380	15.8	20,551
III	57,855	5.6	38,346	27.2	19,509
IV	62,972	13.0	42,812	34.5	20,159
1988: I	60,296	17.2	44,499	39.2	15,797
II(p)	65,136	14.4	47,273	29.9	17,863

Japan's Total Trade in Yen Terms

(in billions of yen)

	Exports (f.o.b.)	Change Over Year-Earlier Period	Imports (c.i.f.)	Change Over Year-Earlier Period	Trade Balance
1983	¥34,909	1.4%	¥30,014	-8.1%	¥4,895
1984	40,325	15.5	32,321	7.7	8,004
1985	41,956	4.0	31,085	-3.8	10,871
1986	35,290	-15.9	21,551	-30.7	13,739
1987	33,315	-5.6	21,737	0.9	11,578
1986: I	8,674	-12.4	6,334	-24.1	2,339
II	9,119	-17.3	5,399	-33.3	3,720
III	8,632	-18.5	4,758	-36.8	3,874
IV	8,865	-15.1	5,060	-28.9	3,806
1987: I	7,960	-8.2	4,959	-21.7	3,002
II	8,153	-10.6	5,207	-3.6	2,946
III	8,507	-1.5	5,644	18.6	2,864
IV	8,694	-1.9	5,928	17.2	2,767
1988: I	7,715	-3.1	5,687	14.7	2,028
II(p)	8,158	0.1	5,919	13.7	2,239

Japan's Trade with the United States in Dollar Terms

(in millions of dollars)

	<u>Exports</u> (f.o.b.)	<u>Change Over</u> <u>Year-Earlier</u> <u>Period</u>	<u>Imports</u> (c.i.f.)	<u>Change Over</u> <u>Year-Earlier</u> <u>Period</u>	<u>Trade</u> <u>Balance</u>
1983	\$42,829	17.9%	\$24,648	1.9%	\$18,181
1984	59,937	39.9	26,862	9.0	33,075
1985	65,278	8.9	25,793	-4.0	39,485
1986	80,456	23.3	29,054	12.6	51,401
1987	83,580	3.9	31,491	8.4	52,090
1986: I	16,696	25.1	6,278	-7.3	10,418
II	20,921	24.3	8,305	25.1	12,616
III	21,280	28.1	7,525	23.1	13,755
IV	21,559	16.7	6,946	10.8	14,613
1987: I	18,001	7.8	6,986	11.3	11,015
II	21,181	1.2	7,592	-8.6	13,589
III	21,628	1.6	8,252	9.7	13,376
IV	22,770	5.6	8,660	24.7	14,110
1988: I	19,859	10.3	10,088	44.4	9,772
II(p)	21,600	2.0	10,439	37.5	11,161

Japan's Trade with the United States in Yen Terms

(in billions of yen)

	<u>Exports</u> (f.o.b.)	<u>Change Over</u> <u>Year-Earlier</u> <u>Period</u>	<u>Imports</u> (c.i.f.)	<u>Change Over</u> <u>Year-Earlier</u> <u>Period</u>	<u>Trade</u> <u>Balance</u>
1983	¥10,179	12.9%	¥5,855	-2.3%	¥4,323
1984	14,221	39.7	6,364	8.7	7,858
1985	15,583	9.6	6,213	-2.4	9,369
1986	13,564	-13.0	4,918	-20.9	8,646
1987	12,148	-10.4	4,582	-6.8	7,566
1986: I	3,191	-6.9	1,203	-30.7	1,988
II	3,589	-15.4	1,421	-15.1	2,168
III	3,355	-16.3	1,190	-19.3	2,165
IV	3,429	-12.1	1,104	-16.9	2,325
1987: I	2,786	-12.7	1,083	-9.9	1,703
II	3,034	-15.5	1,086	-23.6	1,948
III	3,180	-5.2	1,215	2.1	1,965
IV	3,148	-8.2	1,198	8.5	1,950
1988: I	2,541	-8.8	1,290	19.1	1,251
II(p)	2,705	-10.8	1,307	20.4	1,398

in the April-June quarter compared to a year earlier. Imports benefit from the double-barrelled effect of a robust economy, which pulls in imports as it grows, and a rising yen, which makes purchases from abroad cheaper, expanding their volume. Manufactured goods are now a higher percentage of imports than ever before. Since they expand more rapidly with economic growth than other imports, this suggests that imports overall may have become more responsive to an expanding economy.

In the next few months, the effort to reduce Japan's overall trade surplus in dollars will get a little help if the dollar's recent strength causes the dollar price of Japanese imports to edge upward. The effect will be at least partly offset if, as some evidence suggests, Japanese exporters raise dollar prices as a result of past yen appreciation and strong domestic markets. Over a longer period of time, however, export and import volumes would respond to the higher prices. These crosscurrents are one reason most forecasters see the trade surplus narrowing only slightly during the second half of 1988.

Douglas Ostrom

Unemployment Dropping In Japan

Japan's experience with the high yen continues to produce surprises. Not only has the economy grown much faster than expected since hitting bottom in late 1986, unemployment has declined since peaking at 3.2 percent in May 1987. At 2.5 percent the figure for May is the lowest in more than three years and below the annual average for 1983 and 1984 when the yen was much weaker. Further, at a seasonally adjusted 0.99 in May, the effective job-opening ratio means that the number of employers seeking workers almost exactly equals those seeking employment. This ratio stands at the most favorable level since September 1974.

The figures suggest that the run-up in the yen's value has not wreaked quite the damage once expected. To the extent firms have trimmed costs to remain competitive in the face of currency appreciation and reduced employment in the process, those displaced or not hired appear to have found work elsewhere. Similarly, the movement of production offshore so far has had little effect on existing jobs or employment opportunities.

In its 1987 white paper, released this month, the Ministry of Labor sees the employment situation as more complex. The low and declining unemployment rate masks workers' problems with extended commuting times, long working hours and high prices. Even the unemployment situation is not as good as it looks; among some groups the employment situation is worsening. The white paper notes that joblessness has risen particularly among those just beginning their employment history or approaching the end of it. Among men 15 to 19, the rates are high, according to the white paper, because the forms of part-time work are changing, among other reasons. Unemployment is also high for men 60 to 64 because job opportunities are lacking.

The Ministry of Labor also hints that the current jobless rate of 2.5 percent may be about as low as can reasonably be expected. Because of the age and geographic distribution of the existing unemployment, further increases in economy-wide demand may not increase employment opportunities for the jobless.

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J E I

R E P O R T

A Two-Part Report: A and B

NO. 30A

August 5, 1988

THE TAKESHITA GOVERNMENT:
INTERNATIONAL TRIUMPHS AND DOMESTIC CHALLENGESSummary

Prime Minister Noboru Takeshita took office last November with a reputation for being a political technician adept at the behind-the-scenes maneuvering and consensus-building that is the essence of Japanese politics. While he was expected to excel in managing domestic policy issues -- an area where his predecessor, Yasuhiro Nakasone, sometimes encountered difficulties -- there were concerns that his low-key style and apparent lack of interest and experience in foreign policy would leave him ill-equipped to deal with Japan's increasing global responsibilities.

After approximately nine months in office, however, an entirely different scenario has unfolded. Mr. Takeshita has repeatedly surprised critics with his outgoing approach to diplomacy. Ironically, his biggest challenges appear to be on the domestic policy front. The true test of the prime minister's vaunted political savvy may well come in shepherding through the Diet a comprehensive tax reform proposal. The extraordinary Diet session that convened in mid-July for the express purpose of considering the tax legislation could prove to be a turning point in Mr. Takeshita's prime ministerial tenure.

The Takeshita Style: Quiet But Effective

Since entering office in November 1987, Noboru Takeshita has administered his government in the deliberative, consensus-oriented manner typical of

most postwar Japanese prime ministers, save his immediate predecessor, Yasuhiro Nakasone. Unlike the sophisticated and innovative Mr. Nakasone, Prime Minister Takeshita has not championed "new ideas." As the consummate party man, he has relied on Liberal Democratic Party officials and government bureaucrats to formulate policy proposals or rework the initiatives of his predecessors. The academics and bunkajin (men of culture) who actively participated in Mr. Nakasone's policymaking circle do not have Mr. Takeshita's ear. Instead the veteran political operator and deal maker has sought to implement, rather than conceive of, policies. As one American expert on Japanese politics described the prime minister, "he is essentially an arbiter who prefers to let others bring ideas to him. . . . His specialty is working within the existing party and government structure . . . and he does this very well!"¹ This modus operandi has been carefully developed and honed during Mr. Takeshita's 37 years in public service and in large part it has propelled him to the leadership position he enjoys today.

The prime minister's speech to the Diet November 27, 1987, for example, contained general references to the need for Japan to contribute more to the international community and the importance of reforming the tax system and halting the soaring prices of real estate. Certain members of the Japanese press criticized the address for its ambiguities and reiterations of past governments' policy goals. As the new year unfolded, however, the prime minister further elaborated on these declarations after the relevant government agencies had fleshed out specific proposals. Although some might argue that this approach lacks the originality and dynamism required of a global leader, within the Japanese context it has proven to be quite effectual. As one of his former aides pointed out, Mr. Takeshita's forte is not in mastering the details or conceptualizing new approaches to an issue but in understanding which Diet members can be induced to offer him help.²

In fact, the prime minister's political acumen, reliance on bureaucratic expertise and careful regard for the consensus-driven decisionmaking process appear to have facilitated Diet action on a number of proposals. By the regular Diet session's May 26 closing, the legislature had passed 75 of the 83 bills introduced by the government, including the ¥56.7 trillion (\$453.6 billion at ¥125=\$1.00) FY 1988 general account budget and long-sought legislation aimed at reversing the spiral in land prices. This constituted a 90.4 percent passage rate, the highest for a regular Diet session during the last 30 years. The prime minister also struck a deal with the opposition parties to cut personal income taxes at the national and local levels for 1988 and to postpone the introduction of the controversial indirect tax -- a bid for less contentious consideration of tax reform during the extraordinary Diet session.

¹Remarks by Nathaniel Thayer at Johns Hopkins School of Advanced International Studies seminar, "Developments in U.S.-Japan Relations," April 14, 1988.

²Urban C. Lehner, "Takeshita May Lack Pizazz But His Persistence Is Producing Some Surprising Breakthroughs," Asian Wall Street Journal, July 18, 1988.

His strategy also proved effective in winning Diet support on heated international issues, such as the long-simmering beef and citrus trade issue. Mr. Takeshita quietly orchestrated support for an agreement with the United States through months of behind-the-scenes negotiations with key LDP representatives of farming interests. According to parliamentary officials, both the LDP and the opposition parties were pleased with the outcome of the first regular Diet session and attributed this "rare occurrence" to the prime minister's "non-confrontational approach that diffused possible crises in Diet politics."³ The Takeshita style is predictable, conscientious and low-key but it has produced policy results in areas that eluded his more extroverted predecessor.

International Achievements

Although no one doubted that Mr. Takeshita's 30-odd years in LDP politics would serve him well in managing domestic policy issues, his apparent disinterest and inexperience in foreign affairs initially was viewed as a major liability for his administration. Given Japan's emergence as a global economic power, Japanese political observers maintained, another bold, visionary, internationally minded leader like Yasuhiro Nakasone was needed if Tokyo were to fully embrace the responsibilities attendant with its leadership role. (The former prime minister, in fact, has continued to hover in the background, perhaps hoping to further his diplomatic mission through much publicized plans to establish a foreign policy think tank and international speaking engagements.)

As if to deliberately challenge his critics -- and definitively answer questions as to who is really at the foreign policy helm -- Prime Minister Takeshita since entering office has embarked on an ambitious agenda of international visits. In certain instances he has seized the initiative by outlining ways to settle troublesome issues or proposing new plans generated by the Foreign Ministry, Mr. Nakasone or others. Chart 1 indicates that Mr. Takeshita has actively sought the tutelage of Foreign Ministry bureaucrats to prepare him for the diplomatic tasks ahead.

Chart 1: Visits to Prime Minister Takeshita by Representatives
of the Top Five Ministries

(November 1987-April 1988)

	Visits
1. Foreign Ministry*	55
2. Finance Ministry	23
3. Ministry of International Trade and Industry	17
4. Ministry of Agriculture, Forestry and Fisheries	14
5. Japan Defense Agency	9

*Does not include visits from ambassadors.

Source: *Japan Economic Journal*

³Shinji Ito, "Diet Session Ends 'Full Of Results'," Japan Times, May 26, 1988.

Beginning with his December 1987 trip to the Philippines to attend the summit meeting of the Association of Southeast Asian Nations and building to his "first act finale" at the June summit meeting of the major industrial nations in Toronto, Mr. Takeshita has demonstrated to domestic and international audiences that he is able to navigate Japan through the often rough seas of global politics. Consider the following achievements:

The Toronto Summit - Unlike at previous summits where Tokyo found itself on the defensive due to Japan's huge trade surplus, the prime minister went to Toronto with an impressive array of statistics substantiating the effectiveness of Japanese government policies designed to foster domestic demand-led growth and reduce the trade surplus. Japan's trade surplus has been declining in dollar terms since the second quarter of 1987 (see JEI Report No. 298, July 29, 1988). Tokyo estimates that 1987's surplus of \$87 billion will decline to \$81 billion this year. There is also substantial evidence that stimulative fiscal policies and other government measures are gradually restructuring the economy away from its dependence on exports.

Capitalizing on this position of strength, M. Takeshita promoted Japan's proposals on a variety of issues at the summit, including a plan to spend \$50 billion in foreign aid in the next five years and a program to deal with the debt of wealthier Third World debtor nations (see JEI Report No. 248, June 24, 1988). Granted, the current government is not wholly responsible for Japan's booming economy, and much of the groundwork for the aid initiatives was laid by the preceding administration. Nevertheless, his domestic constituency and summit counterparts credit Mr. Takeshita with demonstrating a refreshing new leadership role for Japan.

U.S.-Japan relations - Within the first year of his tenure, Prime Minister Takeshita has helped resolve some of the toughest issues in bilateral economic relations. These include: procedures to allow U.S. firms greater access to Japanese public works projects; an agreement to eliminate Japan's import quotas on beef and oranges; a new accord governing bilateral cooperation in science and technology; a revised bilateral nuclear cooperation pact; strengthened Japanese controls on the export of militarily related technology; Tokyo's agreement to assume a bigger share of the costs of maintaining U.S. troops in Japan, and joint development of Japan's next-generation fighter support aircraft. U.S. Ambassador to Japan Mike Mansfield credited Mr. Takeshita's results-oriented drive in stating that "for the first time in memory there are no major U.S.-Japan trade issues on the table." While much of the spadework on these issues was done before Mr. Takeshita entered office, some analysts contend that only an experienced political practitioner like the prime minister could have garnered the necessary domestic support to bring these proposals to fruition.

Japan-European Community relations - Mr. Takeshita embarked on a seven-nation tour of Europe in May and early June to sow the seeds for improved relations with these countries. Although there were no major breakthroughs on pending trade disputes, the prime minister's promise to take a "personal interest" in facilitating resolution of certain cases generally improved the atmosphere. His European counterparts also responded favorably to his first major foreign policy address in which he presented his "International Cooperation Initiative" -- a three-part plan involving Japanese support for international

peace initiatives, increased cultural exchanges between Japan and other countries and expanded official development assistance. Mr. Takeshita took advantage of this opportunity to do some preliminary lobbying against a potential "fortress Europe" response to full economic integration of the European Community, scheduled to be completed by 1992.

Japan-ASEAN relations - The Takeshita administration has demonstrated an even greater economic commitment than its predecessors to its Southeast Asian neighbors through expanded foreign aid. It also has promised to consider special financial assistance to ASEAN members plagued by huge external debts (see JEI Report No. 27B, July 15, 1988). The security area, however, is where impressive gains have been made. At the July 7 Japan-ASEAN ministerial meeting, Foreign Minister Sosuke Uno indicated that Tokyo would consider funding an international peacekeeping force for Kampuchea as well as sending civilian personnel to supervise elections there after peace is restored. Since Japan's longstanding policy prohibits the dispatch of its Self Defense Forces to another country, Tokyo has increasingly offered "non-military assistance to troubled parts of the world, usually in the form of economic assistance. The proposed dispatch of civilian personnel would appear to be in line with the Takeshita "International Cooperation Initiative."

Also significant was Japan Defense Agency director general Tsutomu Kawara's June 29-July 6 tour of the region -- the first such visit since the end of World War II by a high-level Japanese defense official. The main purpose of the trip was to reassure regional leaders that Japan will never become a major military power, even though the country has been steadily improving and expanding its defense capabilities in accordance with U.S. requests.

Japan-Australia relations - During his July 1-4 trip to Canberra, Prime Minister Takeshita and his Australian counterpart Bob Hawke concluded a comprehensive accord to improve cooperation between the two countries. They also agreed to hold senior working-level consultations on the possible impact on the Asian Pacific region of the U.S.-Canada free trade agreement and the European Community's integration plan. Japan and Australia are concerned about the exclusionary implications of these trade agreements. Although Mr. Takeshita did not put forth his own administration's proposal for a summit meeting of the Pacific Rim nations, he did advance Mr. Nakasone's proposal to establish a "Pacific League of Parliamentarians." This plan, which was well received in Canberra, would bring together legislative representatives from the democracies in the Asian Pacific region.

The only foreign policy area where the prime minister may have seriously stumbled was in his handling of a cabinet official's repeated gaffes denying Japan's aggressive behavior in World War II. In an April 22 statement to reporters visiting Tokyo's Yasukuni Shrine, which is dedicated to the war dead, Seisuke Okuno, director general of the National Land Agency, stated that Japan was simply "protecting itself against the white race that had turned Asia into a colony." This remark was followed by statements in which he maintained that the Sino-Japanese war had started "accidentally" and that Japan had no intention of depriving China of its land and assets. He later refused to retract these statements.

Mr. Takeshita, who is planning his first trip to China in late August, dissociated his government from Mr. Okuno's remarks. However, he did not fire his Land Agency chief until opposition parties forced his hand by threatening to draft a dismissal resolution. The resolution would have presented the prime minister with a major problem: he would have been compelled to support Mr. Okuno out of party loyalty -- an act that would have been inexcusable to China, South Korea and indeed the world community.

Some observers suggested that the incident would hurt the Takeshita administration both domestically and internationally. On the domestic front, there was speculation that the prime minister would never be able to push legislation through the Diet that would halt the soaring prices of land since Mr. Okuno had played a crucial behind-the-scenes role. On this point, Mr. Takeshita has proven them wrong. The foreign policy impact is still problematic; whether or not Beijing attributes the prime minister's handling of this episode to his general lack of appreciation for the delicate balance in Sino-Japanese relations will become better known later this summer.

Tax Reform: A Make-Or-Break Issue

Although the prime minister has surprised his supporters and detractors alike with the success of his international forays, the true test of his leadership and political mettle will be in shepherding through the Diet legislation aimed at restructuring Japan's tax system. The continued challenges of controlling land prices and liberalizing the agricultural sector pale in comparison to what is at stake with tax reform. The prime minister has explicitly stated that the fate of his government hinges on successful passage of tax reform legislation. No one need remind him of Mr. Nakasone's fate after his effort to enact a tax reform plan last year failed to garner the support of his own party.

Prime Minister Takeshita, however, has a couple of factors working in his favor. Foremost, there is far broader recognition among the voting public that the existing system must be overhauled. The Nakasone effort, although a devastating political defeat for the former prime minister, served an invaluable educational function at the grass roots. Mr. Takeshita, in his inimitable cautious style, released portions of his plan over a period of months to gauge public acceptance. He also introduced a new wrinkle to the standard tax policy process by forming a committee of Ministry of Finance and LDP representatives that deliberated various proposals and drafted a final plan.

Mr. Takeshita's main problem will be in garnering the acquiescence of the opposition parties, which strongly oppose one component of the package -- a new indirect tax now labeled a consumption tax. They have demanded that the prime minister dissolve the lower house for a general election in which taxpayers can have a say on the proposal. Mr. Takeshita thus far has refused to go this route. Nevertheless, he recognizes that he risks losing stature on the tax reform issue; if the opposition parties refuse to participate in Diet proceedings and the prime minister pushes the law through in their absence, he will be widely regarded as resorting to the "tyranny of the majority" -- something not done in Japanese politics.

The tax reform package submitted to the Diet is stimulative, with total tax reductions (¥5.6 trillion or \$44.8 billion in FY 1990) outweighing increases (¥3.2 trillion or \$25.6 billion). The controversial consumption tax

would add a 3 percent tax on all goods and services except for: food, medical fees paid by public insurance, tuition fees, public works projects, real estate transactions, transfers of securities, insurance, loans, exports and international postal transfers. Firms with annual sales of less than Y30 million (\$240,000) will be exempt from the consumption tax, and those with annual sales under Y60 million (\$480,000) will pay a reduced rate. The exemptions have made the entire package more palatable to the business community and other interest groups that support the LDP.

The prime minister reached an agreement with the opposition parties at the close of the regular Diet session in May to convene an extraordinary session to act on tax reform. Although Komeito, the Japan Socialist Party and the Japan Communist Party have stood firm in their opposition to the indirect tax, Mr. Takeshita's renowned deal-making skills appeared to be softening the Democratic Socialist Party. Saburo Tsukamoto, chairman of the fourth-largest party, offered to discuss the package if the LDP agreed to amend the existing tax loopholes first and separate the tax-cut bills from the rest of the package. With the support of one opposition party, the LDP could claim that it did not ram tax reform through the Diet. Without such backing, the ruling party could alienate voters, possibly weakening its strength at the grass roots and costing the LDP seats during the next election.

As the opening of the special Diet session approached, the prospects for tax reform did not appear all that bleak for the Takeshita administration. However, Asahi Shimbun, a newspaper known for its anti-government stance, further stoked the opposition parties' fires by questioning unusually high profits from stock transactions of personal aides to several key political figures. Among these were aides to Mr. Takeshita, Mr. Nakasone, Finance Minister Kiichi Miyazawa and LDP secretary general Shintaro Abe. Shares of Recruit Cosmos Co., Ltd. initially were sold for Y1,200 each (\$9.60) to 76 people, including the personal aides, when the company was strapped for cash in 1984. When the real estate firm went public two years later, the aides and others sold their shares when the price per share topped Y5,000 (\$40), earning between Y50 million (\$400,000) and Y120 million (\$960,000) each. Such deals, although legal and not unheard of in Japan, raise ethical questions since the investors were linked to central and local government officials.

Although the prime minister and other top officials were not personally involved and nothing illegal appears to have been done, public outrage has been quite strong, with some people comparing the episode to the 1976 Lockheed scandal that involved kickbacks to government officials and eventually forced former Prime Minister Kakuei Tanaka to resign his Diet seat. Mr. Takeshita has criticized his aide's conduct as improper, and it is almost certain that the aide will step down. Nevertheless, the opposition parties grasped at this straw as a means to block passage of the consumption tax; they insisted on a full airing of the scandal during the extraordinary session. Their goals were to further delay consideration of the tax measures and to score points with voters by attempting to show that LDP leaders resorted to insider trading to fill their campaign chests while asking the public to pay more taxes.

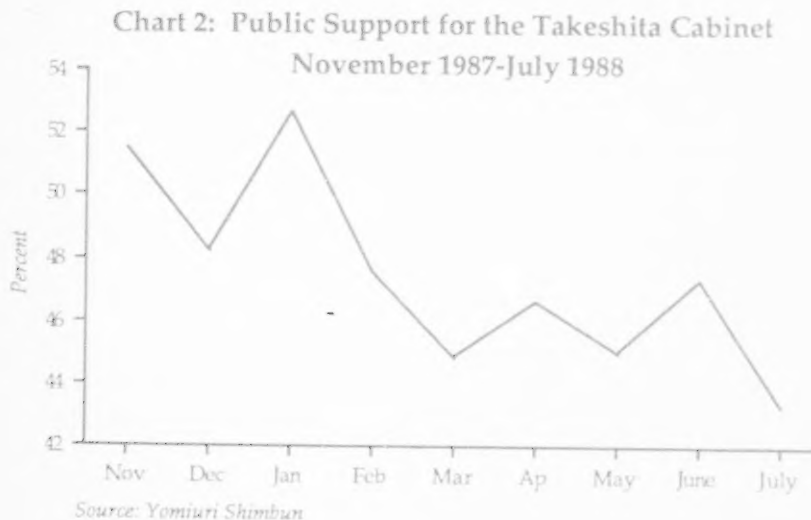
Behind-the-scenes wheeling and dealing resulted in the Takeshita administration cutting another deal with the opposition parties to convene the special session July 19 under the following conditions: (1) acceding to opposition demands, the ruling party agreed to act on the tax cut proposal

before Mr. Takeshita addressed the Diet -- a highly unusual protocol exception for which the opposition parties agreed not to boycott the session; (2) both sides agreed to the creation of a forum to discuss how to correct "tax inequalities" and to map out a mid-term administrative reform and social welfare plan -- an LDP attempt to keep the indirect tax proposal alive, and (3) the LDP agreed to examine the public policy implications of the stock scandal in the budget committees of both houses.

As the above suggests, Mr. Takeshita, for all his bargaining power, may yet stumble and fall on this issue. The opposition parties already appear to be chipping away at what many feel is the relatively "uncontroversial" part of the total reform package. There is speculation that if the opposition becomes too unreasonable the prime minister may decide to railroad the legislation through the Diet in the fall and then presumably attempt to shore up LDP support at the local level. Another view has Mr. Takeshita calling the opposition's bluff by quickly dissolving the lower house and calling for elections in an effort to restore order to the Diet. In any case, what may well become the prime minister's political fight of a lifetime has just begun, and at this stage no one is willing to place any bets on the outcome.

Prospects: Two Years or Four Years?

A prime minister's ability to contribute meaningfully to Japanese public policy depends entirely on how long his party allows him to lead, which is largely influenced by the breadth of public support he enjoys. After the LDP's June announcement of its sweeping tax reform initiative, Mr. Takeshita's public approval rating fell to 43 percent, which marked a decrease of 10 percentage points since January (see Chart 2). Some regard this gradual decline as typical of a prime minister's first year in office and not unduly alarming.⁴ Mr. Nakasone, by comparison, was able to sustain LDP backing and serve two consecutive two-year terms, even though his public approval rating sometimes dipped precariously below 30 percent.



⁴Thayer, op. cit.

The prevailing view in Tokyo, however, is that Mr. Takeshita's LDP colleagues will be carefully watching how the electorate responds to the prime minister during these next crucial months. If Mr. Takeshita is unable to get the tax package through the Diet, he will be out of office in 1989, according to conventional wisdom. Not only would he have lost his domestic constituency, but he also might end up losing his effectiveness in international forums. At the Toronto summit, in particular, the prime minister committed his government to promoting tax reform and deregulation of the distribution system as well as revision of land use policies. The prime minister still has to prove to his industrial nation peers that there is more to his leadership and diplomacy than simply jetting around the world. Without hard proof of leadership his administration might go down in the history books as another traditional Japanese government that was ill-equipped to lead the nation into a new era of expanded global responsibilities.

The LDP leader does possess certain attributes that may well carry him through the tax quagmire. First, he is a familiar figure to the Japanese public. While it was often difficult for the electorate to appreciate Mr. Nakasone's dynamism, Mr. Takeshita's cautious, deliberative style is regarded as nihonteki -- characteristically Japanese. Second, he is a team player both in LDP politics and bureaucratic policymaking. With the exception of Mr. Okuno, the first Takeshita cabinet remains intact, although changes may take place if, or when, the tax package is passed. Within the ruling party, he enjoys far broader support than his immediate predecessor. Mr. Takeshita earned the prime minister's post through painstaking interfactional negotiations, which also resulted in his chief opponents receiving senior cabinet and party leadership positions. Thus, it would be very difficult for a potential successor to effect an ouster at the end of Mr. Takeshita's second year in office unless he had the solid backing of the prime minister and his faction, the largest in the LDP.

The prime minister's first nine months in office have been productive from a diplomatic standpoint -- and he has certainly dispelled preconceived notions about his lack of ability in global affairs. Whether Mr. Takeshita will be remembered as a true governmental leader or simply as a political functionary will be better known as the rest of his term unfolds.

For further information, contact Barbara Wanner.

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The views expressed in this report are those of the author and do not necessarily represent those of the Japan Economic Institute.

APPENDIX

The Takeshita Cabinet

July 1988

<u>Position</u>	<u>Name</u>	<u>Faction</u>
Prime Minister	Noboru Takeshita	Takeshita
Deputy Prime Minister	Kiichi Miyazawa	Miyazawa
Finance	Kiichi Miyazawa	Miyazawa
Justice	Yukio Hayashida	Miyazawa
Foreign Affairs	Sosuke Uno	Nakasone
Education	Gentaro Nakajima	Abe
Health and Welfare	Takao Fujimoto	Komoto
Agriculture, Forestry and Fisheries	Takashi Sato	Abe
International Trade and Industry	Hajime Tamura	Takeshita
Transportation	Shintaro Ishihara	Abe
Posts and Telecommunications	Masaaki Nakayama	Nakasone
Labor	Taro Nakamura	Takeshita
Construction	Ihei Ochi	Nakasone
Home Affairs	Seiroku Kajiyama	Takeshita
State Ministers:		
Chief Cabinet Secretary	Keizo Obuchi	Takeshita
Management and Coordination Agency	Osamu Takatori	Takeshita
National Land Agency	Hideo Utsumi*	Takeshita
Japan Defense Agency	Tsutomu Kawara	Miyazawa
Economic Planning Agency	Eiichi Nakao	Nakasone
Science and Technology Agency	Soihiro Ito	Komoto
Environmental Agency	Tohio Horiuchi	Abe
Okinawa and Hokkaido Development Agencies	Shigeru Kasuya	Miyazawa
Cabinet Legislative Bureau	Osamu Mimura	Unaligned

*Replaced Seisuke Okuno May 13, 1988.

Factional Alignments in the Liberal Democratic Party

November 30, 1987

<u>Faction</u>	<u>Number of Members</u>
Takeshita	114
Miyazawa	89
Nakasone	87
Abe	87
Komoto	31
Nikaido	15
"Neutrals"*	12
Independents	10

*Former Tanaka faction members currently unaligned.

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JEI

R E P O R T

A. Two-Part Report: A and B

NO. 31A

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JAPANESE INSURANCE COMPANIES

Summary

Japanese insurance companies have grown into giants with few people noticing. Heavy layers of regulation, different legal systems and demographic considerations have limited market penetration by Japanese firms in the United States and vice versa. Increasing U.S. investments by Japanese manufacturers, banks and securities companies, however, may eventually make Japanese insurance companies as important as providers of insurance here as they already are as investors.

In Japan major changes are under way. Competition among insurance companies and between them and other financial institutions is increasing. The Ministry of Finance has struggled to maintain a level playing field for all the contestants. The winds of deregulation and competition that are reaching the Japanese companies on their home turf may eventually push them farther into the U.S. market, either to learn ways of coping or because the profits to be earned in the huge American market would be more tempting than previously.

Introduction

Nippon Life Insurance Co. is the largest life insurance company in the world as measured by assets, edging out Prudential Insurance Co. of America. It is also larger in terms of revenues than any Japanese manufacturing company except Toyota Motor Corp. According to Forbes' ranking of international firms by 1987 revenues, the insurance giant is the twelfth-largest company in the world outside the United States.

Nippon Life and other large Japanese insurance companies are well-known on Wall Street. Their portfolio adjustments can affect the whole market. At home, they loom even larger. Nippon Life, for example, is the largest stockholder in the Tokyo Stock Exchange, the world's biggest, in which it owns 3 percent of the total shares. Yet Japanese insurance companies remain something of a mystery compared to their American counterparts or other Japanese firms of comparable size. This report explains who these companies are, what they do and how they fit into the economy of Japan and, increasingly, the world economy.

What Insurance Companies Do

Insurance protects against risk. Those individuals and firms that buy insurance pay a charge called a premium that the insurance company invests until it is needed to pay any claims. Insurers make their money on the difference between what they receive in premiums and investment income and what they pay out in claims and expenses. Beyond this, things get more complicated. For instance, a mutual insurance company uses part of its premium income to invest in itself, thereby eliminating the need to issue stock to the public. Such insurance companies, which are in effect owned by their customers, are common in both the United States and Japan.

A company may concentrate on one kind of insurance. In fact, in Japan and, to a lesser extent, in the United States specialization has resulted in two broad types of companies: life insurance companies and property and casualty companies, called non-life insurance companies in Japan.

This distinction is becoming a more difficult one to make. A non-life insurance company offers health insurance, but a life insurance company may offer a plan to pay benefits to those who are very sick. In addition, insurance companies in both countries have developed products that go beyond protection against risk. To cite just one example, many policies allow those who have filed no or few claims in the contract period to receive a share of the return on the investments made with the premium payments. These policies, which in Japan are offered by both life and non-life companies, are in effect hybrids of investment and insurance products. Their increasing popularity has blurred the distinctions in both the United States and Japan among different kinds of insurance companies and between insurance companies and other financial institutions such as banks and brokerage houses. For government regulators overseeing different policies for each industry, these changes have created a big headache.

For really large potential disasters, insurers do not want to bear the entire risk themselves. No Japanese insurance company would want to be liable for paying claims resulting from a repeat of the 1923 earthquake that leveled Tokyo, but even tragedies such as the loss of multimillion-dollar airplanes could seriously hurt the bottom line. Reinsurance has developed in response to this need: insurance companies in effect share their risks and returns with other companies, preferably ones that would otherwise insure very different risks. Going abroad has been an easy way to accomplish this, turning

reinsurance into an international business. For example, when an Air France Airbus A320 crashed in France in June, insurance companies in France, the United Kingdom and elsewhere shared in making up the \$45 million loss.

Even if insurance companies eventually end up paying in claims most of what they collect in premiums, in the interim they have millions of dollars to invest. This is especially true for life insurance companies, where all but the oldest policyholders pay far more in premiums than they collect in claims in a given year. Compared to other investors, insurance companies have a long-term perspective. If the claim against the funds is 40 years away, as it might be in the case of a life insurance policy, the company need not worry much about whether the price of a stock falls this year, for example. Nor is it worried much about liquidity -- the ability to sell the investment quickly for cash -- since the insurer will not need the funds for a long time.

Portfolio diversification is important for insurance companies, allowing them to invest in areas outside their insured risks and to hedge their investment bets. Clearly, to the extent that Japanese companies offer earthquake insurance without obtaining reinsurance, they would be careful about buying real estate in the same geographic region. In addition, diversification is considered sound portfolio management strategy for almost anyone. Considering the giants that Japanese insurance companies have become, international investment is something of an imperative. Responding to this need, the Ministry of Finance in August 1986 increased the amount that Japanese companies could invest abroad to 30 percent of total assets from 25 percent and liberalized the percentage of the increase in assets that could be invested overseas; the result has been a rapid expansion in foreign investment, especially in the United States.

Table 1 shows how life insurance companies have invested their money. (Non-life insurance companies have a similar distribution of assets but are much smaller.) Life insurance firms' efforts at diversification are striking, particularly as they head into overseas securities markets and out of domestic lending. Less evident from the table is what is said to be the companies' long-term portfolio management strategy: paying little attention to price fluctuations of the properties they hold, a reflection of their long-term investment perspective.

As investors, Japanese life insurance companies play an important role in the Japanese economy. In 1985 it is estimated that they held 12.3 percent of the shares by market value on Japanese stock exchanges. Since non-life insurance companies owned another 4.1 percent, the 16.4 percent figure for Japanese insurance companies rivaled the 18.4 percent share controlled by Japanese banks.

Life Insurance in Japan

Japan is among the world's best markets for life insurance. More than 90 percent of the population has life insurance, and the amount per person is 50 percent greater than in the United States. The ratio of life insurance in force per level of national income is high and has risen as the economy has grown (see Table 2).

Table 1: Total Assets Held By Japanese Life Insurance Companies

(in billions of yen as of March 31 of each year)

	<u>1975</u>	<u>1981</u>	<u>1986</u>	<u>1987</u>
Cash on Hand and Deposits	Y133.5 (1.2%)	Y445.2 (1.7%)	Y6,248.6 (11.6%)	Y7,570.4 (11.6%)
Call Loans	92.4 (0.8%)	214.9 (0.8%)	146.7 (0.3%)	130.1 (0.2%)
Securities	2,313.5 (20.9%)	7,976.0 (30.4%)	18,981.4 (35.2%)	26,791.9 (41.0%)
Central and Local Government Bonds	60.2 (0.5%)	1,363.3 (5.2%)	3,413.6 (6.3%)	4,570.6 (7.0%)
Corporate Bonds	224.3 (2.0%)	1,422.8 (5.4%)	2,664.9 (4.9%)	3,266.9 (5.0%)
Stocks	2,022.8 (18.2%)	4,520.1 (17.2%)	8,113.9 (15.1%)	11,100.5 (17.0%)
Foreign Securities	5.7 (0.1%)	669.0 (2.5%)	4,668.2 (8.7%)	7,525.3 (11.5%)
Other Securities	0.5 (0.0%)	0.8 (0.0%)	120.8 (0.2%)	328.6 (0.5%)
Loans	7,545.8 (68.0%)	15,685.1 (59.7%)	24,372.2 (45.2%)	25,636.6 (39.2%)
Policy and Premium Loans	617.8 (5.6%)	1,117.4 (4.3%)	1,973.6 (3.7%)	2,174.3 (3.3%)
General Loans	6,928.1 (62.5%)	14,567.7 (55.5%)	22,398.6 (41.6%)	23,462.4 (35.9%)
Real Estate	923.2 (8.3%)	1,647.8 (6.3%)	3,196.2 (5.9%)	3,777.0 (7.0%)
Other Assets	85.3 (0.8%)	288.8 (1.1%)	925.5 (1.7%)	1,411.1 (2.2%)
Total Assets	11,093.7 (100.0%)	26,257.8 (100.0%)	53,870.6 (100.0%)	65,317.1 (100.0%)

Note: Subtotals may not add due to rounding.

Source: Ministry of Finance

Table 2: Insurance and National Income in Japan

(in billions of yen)

<u>Fiscal Year</u>	<u>National Income at Factor Cost</u>	<u>Life Insurance in Force</u>	<u>Life Insurance/National Income</u>
1955	Y8,173.4	Y2,846.4	34.8%
1960	13,290.4	6,997.1	52.6
1965	26,380.4	24,417.3	92.6
1970	61,029.7	78,230.1	128.2
1975	123,990.7	265,417.8	214.1
1980	199,335.2	572,328.3	287.1
1981	208,156.6	642,851.4	308.8
1982	216,859.1	706,176.5	325.6
1983	228,118.8	758,672.4	332.6
1984	239,810.7	807,670.2	336.8
1985	254,519.2	880,734.1	346.0
1986	264,853.0	967,392.8	365.3

Source: Ministry of Finance and Economic Planning Agency

As with other financial services such as banking, life insurance is concentrated in far fewer companies in Japan than here. While more than 2,000 life insurance companies operated in the United States in early 1987, there were only 24 that year in Japan (see Table 3), a figure that has changed little in recent years.

Until recently, however, U.S. companies ranked higher in assets. In 1987 Prudential Life and Metropolitan Life Insurance Co. were both larger than Nippon Life as measured by assets, and Equitable Life Assurance Society of the United States was larger than Dai-ichi Mutual Life Insurance Co., Japan's number-two life insurance company. Together the five companies were the world's largest. Preliminary March 31, 1988 figures, however, put Nippon Life on top, a change that in part reflected the appreciation of the yen in 1987.

The Banking Bureau of the Ministry of Finance regulates insurance companies closely. Both entry into the market and product type are carefully controlled. Moreover, MOF essentially sets industry-wide premiums and dividend rates on policies, although for some types of pension funds, insurance companies pay differing rates of return. Foreign observers describe the arrangement as cozy and comfortable for Japanese insurers compared to the situation in the United States; that is hardly surprising considering the small number of sizeable competitors in Japan.

Conditions would appear to be tailor-made for foreign companies to come in and make a killing. The inability to compete on price, however, limits their options. For Japanese firms, the lack of price competition has diverted

rivalry to distribution, with each major company employing thousands of salespeople. Nippon Life, for example, has 75,900 employees, mostly women, who knock on doors selling policies. For foreign companies, this system is a substantial barrier to entry. While the Ministry of Finance officially welcomes foreign firms, partly because they are seen as a source of new products, few participate in a major way. Table 4 lists foreign life insurance companies operating in Japan. (To this list should be added the four foreign-headquartered companies included by MOF on Table 3's roster of purely domestic companies.) Overall, the Commerce Department estimates that foreign companies have about 2 percent of the life insurance market in Japan.

Table 3: Assets of Japanese Life Insurance Companies

(as of March 31, 1987)

	Assets (millions of yen)	Share	Cumulative Share
Nippon Life Insurance Co.	Y15,144,514	23.2%	23.2%
Dai-ichi Mutual Life Insurance Co.	10,356,739	15.9	39.0
Sumitomo Life Insurance Co.	8,591,651	13.2	52.2
Meiji Mutual Life Insurance Co.	5,555,294	8.5	60.7
Asahi Mutual Life Insurance Co.	4,899,656	7.5	68.2
Mitsui Mutual Life Insurance Co.	3,645,427	5.6	73.8
Yasuda Mutual Life Insurance Co.	3,054,561	4.7	78.5
Taiyo Mutual Life Insurance Co.	2,714,603	4.2	82.6
Chiyoda Mutual Life Insurance Co.	2,031,071	3.1	85.7
Toho Mutual Life Insurance Co.	1,992,353	3.1	88.8
Kyoei Life Insurance Co., Ltd.	1,503,689	2.3	91.1
Daihyaku Mutual Life Insurance Co.	1,251,991	1.9	93.0
Daido Mutual Life Insurance Co.	1,111,848	1.7	94.7
Fukoku Mutual Life Insurance Co.	1,095,894	1.7	96.4
Nippon Dantai Life Insurance Co., Ltd.	934,392	1.4	97.8
Tokyo Mutual Life Insurance Co.	459,277	0.7	98.5
Nissan Mutual Life Insurance Co.	444,083	0.7	99.2
Heiwa Life Insurance Co., Ltd.	236,035	0.4	99.6
Yamato Mutual Life Insurance Co.	119,290	0.2	99.7
Taisho Life Insurance Co., Ltd.	109,801	0.2	99.9
Seibu-Allstate Life Insurance Co., Ltd.	41,882	0.1	100.0
INA Life Insurance Co., Ltd.	8,746	0.0	100.0
Sony Prudential Life Insurance Co., Ltd.	8,605	0.0	100.0
Equitable Life Insurance Co., Ltd.	5,782	0.0	100.0
Total	65,317,184	100.0	100.0

Note: Percentage totals do not add due to rounding.

Source: Ministry of Finance, Hoken Nenkan 1986 (Insurance Yearbook), pp. 86-87.

Table 4: Foreign Life Insurance Companies Operating in Japan

(as of September 1, 1987)

<u>Company</u>	<u>Year Licensed</u>	<u>Capital</u>
<u>American Companies</u>		
Combined Insurance of America	1981	\$28,339,000
Transamerica Occidental Life Insurance Co.	1955	27,578,000
American Amicable Life Insurance Co.	1957	10,000,000
United of Omaha Life Insurance Co.	1964	9,000,000
American Family Life Assurance Co.	1974	3,714,000
American Life Insurance Co.	1954	3,000,000
Trans World Assurance Co.	1973	2,462,000
Old Republic Life Insurance Co.	1973	1,828,000
Midland National Life Insurance Co.	1964	1,504,000
American Fidelity Life Insurance Co.	1973	1,478,000
American Defender Life Insurance Co.	1973	1,200,000
Pioneer American Insurance Co.	1952	750,000
First National Life Insurance Co. of America	1973	500,000
Total		91,353,000
<u>Other Foreign Companies</u>		
National Nederlanden Levensvzederng Maatshappij NV (Netherlands)	1986	27,777,778*

*Dutch guilders converted to dollars at August 31, 1987 exchange rate.

Source: Ministry of Finance

American Family Life Corp. of Columbus, Georgia is one of the best known U.S. life insurance companies operating in Japan. One of six Japanese families uses American Family for some of its insurance needs. Japan in turn is important to American Family; in 1987, 70 percent of its pretax revenues came from Japan. Its flagship product in Japan, cancer insurance, pays benefits to those suffering from the disease while they are still alive. While American Family is permitted to sell a comparable product in 47 American states, cancer insurance remains controversial here. New York's insurance commissioner, for example, is strongly opposed to the product and prohibits its sale in that state.

American Family is an exception. Most U.S. life insurance companies are just not interested in selling insurance in Japan. Connecticut Mutual Life Insurance Co. announced plans in mid-1988 to enter the European and Asian insurance markets in a big way but specifically noted that the plans did not include Japan. The company's executive vice president explained that selling life insurance in Japan "would almost be like reinventing the Toyota and trying to sell it there." Some feel that the Finance Ministry does little to help; rightly or wrongly MOF is seen as making things difficult for new entrants.

New Developments in Life Insurance

As noted above, life insurance may have both investment and insurance components. To the extent that customers buy life insurance in order to save, the product competes with those offered by banks, credit unions and brokerage houses, among others. This competition has involved life insurance companies in the changes affecting financial services. For example, partial deregulation of interest rates on bank deposits in the 1980s has expanded customers' investment options and confronted insurance companies with more competition. On the other hand, the April 1988 elimination of tax-free maruyu accounts at banks and elsewhere made the tax advantages of life insurance loom larger. U.S. life insurance companies had a similar experience when the 1986 tax reforms reduced the tax advantages of individual retirement accounts, making tax-advantaged insurance policies look more attractive.

In Japan one family insurance product, single-premium endowment policies with maturities as short as 10 years or less, has proven especially popular, with sales up 33 percent in June 1988 compared to June 1987. It is unclear to what extent the popularity of these policies is at the expense of traditional savings accounts in banks as compared to other insurance products, but banks have started complaining. There have been calls for insurance companies to suspend sales of such single-premium policies, but the companies counter that consumers are insisting on the product. Banks are also said to support a move to get the insurance companies to increase their premium rates, which would make life insurance less attractive. For whatever reason, life insurance companies have grown rapidly recently; total assets increased from ¥70 trillion (\$560 billion at ¥125=\$1.00) in August 1987 to ¥80 trillion (\$640 billion) in February 1988.

Banks and insurance companies are also rivals on the other side of the balance sheet. As new competitive pressures and international capital requirements have forced banks to trim unprofitable lending arrangements with firms, life insurance companies have moved in, increasing their lending to businesses of all sizes. Between April and June of this year, such lending in Japan was up 20 to 40 percent over the same period of 1987 -- on top of large increases in 1987 over year-earlier levels.

As in the United States, the return on some policies is linked to the performance of the underlying investments that the insurance company makes. Introduced in October 1986, such variable life insurance products push life insurance companies farther into the securities business. While variable life products at first grew rapidly, the stock market crash of October 1987 slowed them down, at least temporarily.

In the United States life insurance companies, since they play the stock market anyway, have taken the next step -- buying brokerage houses so they can offer securities and mutual funds directly, rather than through an insurance product. Prudential, for example, purchased Bache Halsey Stuart Shields Inc., a brokerage firm, in 1981. Many insurance companies also offer mutual funds directly to the public.

Life insurance companies in Japan cannot directly copy their cousins in America. Not only can they not buy or establish a securities firm, they cannot even enter the non-life insurance business in Japan. Doing so overseas is a

little different. Nippon Life paid \$538 million for 13 percent of Shearson Lehman Brothers Inc., the large U.S. securities company, in April 1987. In November Yasuda Mutual Life Insurance Co. bought an 18 percent stake in broker PaineWebber Group Inc. for \$300 million.

Even here, Japanese banks and insurance companies are in regulatory conflict, this time involving U.S. law. Applying the legal principle that separates banking and commerce, the Federal Reserve Board forced Sumitomo Bank, Ltd. to scale back its proposed 1985 involvement with U.S. investment banker Goldman, Sachs & Co. In other words, U.S. law permits Japanese insurance companies to do what was denied a Japanese bank.

With Shearson and PaineWebber, Nippon Life and Yasuda have taken another long step into the rough and tumble sea of America's financial markets. For starters, Nippon Life lost almost half the value of its investment within a few months, at least on paper, as Shearson's stock plummeted in the last half of 1987. But the Nippon Life-Shearson linkup, like the Yasuda-PaineWebber deal, probably has relatively little to do with making money in investment banking in the United States, short or long term. Both get assistance with their foreign asset management capabilities, which could use some help in light of the billions of dollars they lost on their holdings of U.S. Treasury securities when the yen appreciated. Their U.S. partners also could help them in developing more expertise in the American real estate market.

With Shearson, Nippon Life buys into the financial supermarket concept, the idea of offering the customer multiple financial services (savings, credit cards, brokerage services, loans and insurance) under one roof or from one supplier. Shearson is part of American Express Co., which, through its credit card, insurance, brokerage and other financial services branches, has been one of the chief prototypes of such a company. While such financial supermarkets are a long way off in Japan and have yet to prove their worth in the United States, Nippon Life is clearly interested in a relationship with American Express that involves activities other than insurance and brokerage. At a minimum, Nippon Life hopes to gain experience in selling securities to the public in anticipation of the day when that activity is liberalized in Japan.

There were rumors, quickly denied, in April 1988 that that day is fast approaching. Persistent reports, however, suggest that the Ministry of Finance may be considering major changes in the regulatory treatment of the insurance industry. Asset management may be further liberalized, and the distinctions between life and non-life companies, which have become increasingly artificial, may be changed.

Non-Life Insurance Companies

Non-life insurance obviously includes all other kinds of insurance: car, workers compensation, cargo insurance and many more. The legal system plays a role in the kinds of insurance offered and at what prices. Where damage awards are large or easy to obtain, the demand for non-life insurance increases to protect against potential losses. Japanese and American industries differ somewhat in their product mix because litigation works differently in the two countries.

The competitive situation in non-life insurance parallels that in life insurance. The United States had more than 3,500 companies in 1987; Japan had only 23. Competition in the United States has kept profits low; in both 1986 and 1987 the U.S. industry made money only because investment profits exceeded underwriting losses. While some Japanese companies have recorded net underwriting losses in recent years, the industry as a whole has consistently made money on both its underwriting and investment activities.

Table 5 shows Japan's non-life insurance companies. In contrast to the United States, where no company controls more than 10 percent of the market, Tokio Marine and Fire Insurance Co., Ltd. has a 17.6 percent share as measured by assets.

Table 5: Assets of Japanese Non-Life Insurance Companies

(as of March 31, 1987)

	Assets (millions of yen)	Share	Cumulative Share
Tokio Fire and Marine Insurance Co., Ltd.	Y2,579,939	17.6%	17.6%
Yasuda Fire and Marine Insurance Co., Ltd.	1,861,147	12.7	30.3
Taisho Marine and Fire Insurance Co., Ltd.	1,287,999	8.8	39.1
Sumitomo Marine and Fire Insurance Co., Ltd.	1,144,824	7.8	46.9
Nichido Fire and Marine Insurance Co., Ltd.	994,195	6.8	53.7
Nippon Fire and Marine Insurance Co., Ltd.	942,585	6.4	60.1
Dai-Tokyo Fire and Marine Insurance Co., Ltd.	832,539	5.7	65.8
Fuji Fire and Marine Insurance Co., Ltd.	754,056	5.1	70.9
Koa Fire and Marine Insurance Co., Ltd.	693,264	4.7	75.6
Chiyoda Fire and Marine Insurance Co., Ltd.	674,130	4.6	80.2
Dowa Marine and Fire Insurance Co., Ltd.	544,678	3.7	83.9
Nissan Fire and Marine Insurance Co., Ltd.	503,510	3.4	87.3
Daiichi Mutual Fire and Marine Insurance Co., Ltd.	493,963	3.4	90.7
Kyoei Mutual Fire and Marine Insurance Co.	438,177	3.0	93.7
Nisshin Fire and Marine Insurance Co., Ltd.	358,212	2.4	96.1
Taisei Fire and Marine Insurance Co., Ltd.	271,998	1.9	98.0
Asahi Fire and Marine Insurance Co., Ltd.	117,307	0.8	98.8
Toyo Fire and Marine Insurance Co., Ltd.	68,551	0.5	99.3
Taiyo Fire and Marine Insurance Co., Ltd.	45,974	0.3	99.6
Daido Fire and Marine Insurance Co., Ltd.	28,347	0.2	99.8
Allstate Automobile and Fire Insurance Co., Ltd.	22,622	0.2	100.0
Subtotal	14,658,016	100.0	100.0
Toa Fire and Marine Reinsurance Co., Ltd.	169,833		
Japan Earthquake Reinsurance Co., Ltd.	252,492		
Total	15,080,341		

Source: Ministry of Finance, Hoken Nenkan 1986 (Insurance Yearbook), pp. 400-401.

Foreign firms play a minor role in the Japanese industry, despite its relatively high profitability, which might be expected to attract entry. Table 6 shows the leading foreign insurance companies not included in Table 5. American companies clearly dominate the list, but the importance of this activity should not be overestimated. Depending on the measure, all foreign companies taken together have between 1 and 3 percent of the total non-life market in Japan.

Recent Developments in Non-Life

While life insurance companies are more competitive with non-insurance financial institutions than non-life insurance companies are, the latter have not escaped the heat of increased competition entirely. One new wrinkle showing up in more and more products is insurance with a maturity refund, which introduces a savings component to non-life insurance policies; as such it adds non-life insurance companies to those tapping the huge pool of Japanese savings. Such plans mature in three to 10 years in contrast to conventional plans, which last only one year. If there are no claims by the maturity date, policyholders get a refund. Such plans jumped from 7.7 percent of all non-life insurance premiums in 1976 to 30.9 percent in 1985.

One such product is Kyoei Mutual Fire and Marine Insurance Co.'s "long-term ladies insurance with maturity refund," introduced in fiscal year 1985. The insurance policy pays something whether or not its female customers are injured during the policy period. There were 76,000 Japanese women holding the policy as of March 31, 1987.

In a similar vein, Nissan Fire and Marine Insurance Co., Ltd. offers "nice day." Its objective is to make sports outings worry-free. If one gets seriously hurt by an errant golf ball, the company will pay. And the policyholder may get cash back on maturity. This policy has been available since 1987. "Nice day" is one of a series, the others being "nice life" (combining personal accident and property insurance) and "nice guy" (insurance for the executive on personal belongings and accidents).

Non-life insurance companies have joined the life insurers in racing to fill the vacuum left as banks scale back their lending to companies. Between April and June new loans more than doubled the level of a year earlier.

Overseas Expansion

As Japanese manufacturers have moved abroad, they have taken many of their Japanese component suppliers and banks with them. Although the insurance companies that supply them with group life insurance, fire insurance and other products have tagged along, their role in selling policies overseas has so far been limited. To operate successfully in the United States, they need to understand the legal system to evaluate potential liability, American mortality rates to offer profitable life insurance, and licensing requirements and pricing procedures that are as varied as the 50 states setting them. Japanese non-life insurers are faced with a fiercely competitive industry where the rate of return is considerably less than the all-industry U.S. average -- a marked contrast to the return in industries such as cars where, in an earlier era, high profits attracted Japanese entry.

Table 6: Foreign Non-Life Insurance Companies Operating in Japan

(as of September 1, 1987)

<u>Company</u>	<u>Year Licensed</u>	<u>Capital</u>
American Companies*		
Continental Insurance Co.	1972	\$53,566,360
Federal Insurance Co.	1973	13,986,712
Travelers Indemnity Co.	1974	10,000,000
AIU Insurance Co.	1977	8,000,000
Transatlantic Reinsurance Co.	1981	6,041,655
American Home Assurance Co.	1960	4,237,635
CIGNA Insurance Co.	1985	3,000,000
Lumbermens Mutual Casualty Co.	1981	n.a.
Other Foreign Companies		
Zurich Insurance Co. (Switzerland)	1986	102,650,000
Winterthur Swiss Insurance Co. (Switzerland)	1985	89,536,000
Norwich Union Fire Insurance Society Ltd. (UK)	1950	85,000,000
L'Union des Assurances de Paris I.A.R.D. (France)	1966	83,195,000
Skandia International Insurance Corp. (Sweden)	1984	78,989,000
Royal Insurance Public Ltd. Co. (UK)	1975	76,064,497
Eagle Star Insurance Co., Ltd. (UK)	1951	54,518,053
Cornhill Insurance Public Ltd. Co. (UK)	1950	28,035,484
Phoenix Assurance Public Ltd. Co. (UK)	1950	24,516,129
English & American Insurance Co., Ltd. (UK)	1951	22,580,645
Royal Exchange Assurance Co., Ltd. (UK)	1950	21,595,135
New India Assurance Co., Ltd. (India)	1950	20,031,000
Commercial Union Assurance Co. PLC (UK)	1950	16,903,226
Assurance Generales de France I.A.R.T. (France)	1956	14,143,095
Dominion Insurance Co., Ltd. (UK)	1951	13,306,452
Northern Assurance Co., Ltd. (UK)	1950	9,921,952
Alliance Assurance Co., Ltd. (UK)	1950	9,274,193
London Assurance Co., Ltd. (UK)	1950	8,241,936
New Zealand Insurance Co., Ltd. (New Zealand)	1950	7,410,000
QBE Insurance (International), Ltd. (Australia)	1971	5,325,000
Lombard Insurance Co., Ltd. (Hong Kong)	1950	5,121,639
Union Insurance Society of Canton Ltd. (Hong Kong)	1950	3,745,200
Yorkshire Insurance Co., Ltd. (UK)	1950	3,629,032
Hyundai Marine & Fire Insurance Co., Ltd. (Korea)	1976	3,542,300
American International Assurance Co., Ltd. (Hong Kong)	1952	3,361,075
Caledonian Insurance Co., Ltd. (UK)	1950	1,612,903
Malayan Insurance Co. Inc. (Philippines)	1985	563,107
Assicurazioni Generali S.p.A. (Italy)	1987	32,637
Ansvar Mutual Insurance Co. (Sweden)	1979	n.a.

*American firms accounted for 38.5 percent of the capital of foreign companies operating in Japan.

Note: National currencies were converted to dollars at the rates prevailing August 31, 1987.

Table 7: Foreign Activities of Japanese Non-Life Insurance Companies, FY 1986

(in millions of yen)

	<u>Premiums</u>	<u>Percent of All Foreign Business</u>	<u>Foreign as Percent of Total Business</u>
Tokio Marine and Fire Insurance Co., Ltd.	Y19,494	41.3%	1.3%
Taisho Marine and Fire Insurance Co., Ltd.	12,073	25.5	1.6
Sumitomo Marine and Fire Insurance Co., Ltd.	5,083	10.8	0.7
Yasuda Fire and Marine Insurance Co., Ltd.	4,214	8.9	0.4
Nippon Fire and Marine Insurance Co., Ltd.	3,394	7.2	0.6
Nichido Fire and Marine Insurance Co., Ltd.	1,123	2.4	1.9
Dai-Tokyo Fire and Marine Insurance Co., Ltd.	438	0.9	0.1
Koa Fire and Marine Insurance Co., Ltd.	395	0.8	1.5
Chiyoda Fire and Marine Insurance Co., Ltd.	383	0.8	0.1
Nissan Fire and Marine Insurance Co., Ltd.	324	0.7	0.1
Dowa Fire and Marine Insurance Co., Ltd.	276	0.6	0.1
Taisei Fire and Marine Insurance Co., Ltd.	49	0.1	0.0
Kyoei Mutual Fire and Marine Insurance Co.	10	0.0	0.0
Total	47,257	100.0	0.5

By Country

United States (incl. Guam)	30,058	63.6
Singapore	3,447	7.3
Hong Kong	2,590	5.5
Australia	2,072	4.4
Netherlands	1,889	4.0
Saudi Arabia	1,357	2.9
Belgium	1,076	2.3
United Kingdom	839	1.8
Thailand	782	1.7
France	669	1.4
Other	2,478	5.1
Total	47,257	100.0

Source: Computed from Ministry of Finance data.

All this has apparently proved to be a daunting challenge. Japanese non-life insurance companies play a very limited role in the United States, by far their largest overseas market (see Table 7). Both Japanese life and non-life insurance companies are unimportant in the American market compared to insurance firms from the United Kingdom, Canada, the Netherlands and Switzerland.

More often, Japanese manufacturers and insurance companies follow the practices developed by trailblazing U.S. multinationals: they develop relationships of various kinds with indigenous insurance companies to supply insurance products to their local subsidiaries. In fact, a major activity of Japanese insurance companies in the United States is to assist U.S. companies needing a Japanese partner to provide insurance for their operations in Japan.

Travelers Corp., the American giant, has that type of affiliation with Nippon Life, Nippon Fire and Marine Insurance Co., Ltd. and other Japanese insurers. Travelers designs and offers group life insurance to the American subsidiaries of Japanese firms, obviating the need for a Japanese insurance company to get a location-specific insurance license and develop expertise to serve particular groups of American workers. Its Japanese partners do the same for Travelers' American clients with operations in Japan. Travelers' affiliation with its Japanese partners dates back more than 20 years.

Chiyoda Fire and Marine Insurance Co., Ltd. provides another example. Like Mitsui Bank, Ltd., it has a representative office in Lexington, Kentucky to be close to one of its major clients and major shareholder, Toyota Motor Corp., which has a plant nearby. Its Lexington office acts as a go-between with CNA Insurance Co., which sells insurance on its behalf.

Nonetheless, American insurance companies, having watched Japanese firms in industries from ball bearings to banking make significant inroads in the U.S. market, are bracing for more competition. Within 10 years it is widely expected that Japanese life insurance companies will be selling a wide variety of products in the United States. The companies are applying for licenses to sell insurance in more and more states. Their activities may well include non-insurance products such as mutual funds.

Washington has identified insurance as one of the services in which it would like to see international practices liberalized. Substantially freer access for foreign insurance companies is likely in many countries as a consequence of the Uruguay Round of multilateral trade negotiations now going on under the auspices of the General Agreements on Tariffs and Trade, but liberalization is probably still years from fruition. In the meantime, Washington has negotiated bilateral agreements for the same purpose with a number of countries, notably South Korea and Taiwan in 1987. One Dutch insurance company with an American affiliate has argued to the Taiwanese that, as an American company, it should be permitted access. Using their American subsidiaries, Japanese companies could possibly take similar action to enter markets where the United States has bilateral agreements.

Some U.S. insurance companies are chomping at the bit for the right to sell insurance abroad. However, as noted earlier, Japan holds little attraction despite the size of its market. American firms would rather get into

South Korea's market, where only 38 percent of all households have life insurance, than into Japan, where more than 90 percent do. Japan's insurance market, particularly for life insurance, is seen as mature; business for Americans would come out of the hide of Japanese companies, apparently a harder proposition than selling the concept to a country short on life insurance up to now.

Of course, overseas expansion for Japanese insurance companies is in full force on the other side of the balance sheet -- investment. Much of the still miniscule employment of Japanese insurance companies in the United States is to manage their investments in U.S. Treasury securities, real estate and corporate equities. As Japanese insurance companies diversify their product offerings at home, there is likely to be a corresponding diversification in the United States. As insurance policies take on more of an investment dimension, results are likely to be more important than previously suggesting a move toward U.S. securities with higher yields (but also more volatility) than the traditional option of Treasury securities.

A critic might suggest that Japanese insurance companies have experienced more than enough volatility. As the dollar has depreciated against the yen, Japanese insurance companies have been slow to hedge the value of their U.S. investments, leading to billions of dollars of losses the last three fiscal years. Faced with mounting criticism at home over their inept performance and lack of accountability, the companies may have slowed the rate at which they are adding to their holdings of Treasury securities. But recent reports suggest they are becoming more interested in U.S. equities, which are even riskier. Having lost heavily in the first round, they apparently have decided to double their bets in the second.

For further information, contact Douglas Ostrom.

Elizabeth Hughes provided research assistance.

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The views expressed in this report are those of the author and do not necessarily represent those of the Japan Economic Institute.

8/16/88

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J A P A N · E C O N O M I C · I N S T I T U T E

J E I

R E P O R T

A Two-Part Report: A and B

No. 31B
August 12, 1988

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Japan Focuses On Insider Trading

A series of scandals involving questionable stock transactions has focused Japanese attention on the structure of domestic financial institutions and trading practices. The Ministry of Finance and the Japan Securities Dealers Association are considering tougher controls on the sale of listed and unlisted shares as well as the creation of stronger oversight and enforcement bodies. As securities firms institute internal safeguards against insider trading, observers wonder if they will be effective without a complete revamp of the nation's financial and industrial structure.

Japan has been rocked by three stock-related scandals within the past 12 months.

However, a survey by the daily Nihon Keizai Shimbun hints that, on balance, competitive conditions appear to be changing little. In 100 key products and services, the leading firm changed in five business lines last year, down from seven in 1986, but up from four each in 1984 and 1985. The newspaper's three-firm concentration ratio (the percentage of an industry's output accounted for by the three largest producers) declined in about as many industries as it increased. Industries producing beer and detergents, two supposedly mature products where market shares are normally stable, saw dramatic changes as new products -- concentrated detergents and dry beer -- boosted the share of the innovators. If instability of leading firms and low concentration ratios indicate competitive vigor, these data suggest little change in 1987 compared to 1986.

Restructuring, of course, is an ongoing process. As Japanese firms continue to adjust to changes at home and abroad, competitive conditions also will change. Whether increases and decreases in competition in specific industries will cancel out over the whole economy remains an open question.

Douglas Ostrom

Japan Continues To Whittle Down Current Account Surplus

Slow but steady. That phrase has become the stock description of Japan's progress in reducing its huge current account surplus. The balance in merchandise trade, services and transfers has been contracting by \$2.5 billion to \$3.6 billion a quarter on a year-to-year basis since July-September 1987, including a drop of \$3.4 billion in this year's April-June period (see Table 1). Analysts caution, however, that headway from now on could be measured in millions of dollars instead of billions.

Simple arithmetic alone yields this possibility since the starting point for future drops in the current account surplus will be the reduced numbers of the last four quarters. But there is another factor at work. Exports in dollar terms are expanding at a faster pace because of an upturn in volume, while the growth of purchases from abroad, although still robust by any definition, seems to be losing a little steam (see JEI Report No. 29B, July 29, 1988). Japan's trade surplus, in short, could increase -- if not in the current quarter, then in the October-December period -- if recent trends hold up. A bigger deficit in services will counterbalance this development but only partly since the greater red ink expected in the travel and passenger transportation category will be offset to a large extent by the continuing jump in net investment income.

The prospect of a slowdown in the already snail-paced progress of trimming the current account surplus or even an end to this process is certainly unsettling for Japanese government officials and business leaders counting on a smaller black-ink figure to dampen protectionist sentiment here and in Europe. What interests their American counterparts, though, is the amount of Japanese long-term capital moving overseas in coming months. Forecasting the outlook for direct investment is simple since there is nothing on the horizon that should prevent a repeat of the results in 1988's first half, when Japanese investment in offshore manufacturing, banking, real estate and other activities was running at nearly twice 1987's record-setting pace.

Table 1: Japan's Balance of Payments

(in millions of dollars)

	<u>Trade Balance</u>	<u>Exports (f.o.b.)</u>	<u>Imports (f.o.b.)</u>	<u>Services (net)</u>	<u>Current Account Balance</u>	<u>Long-Term Capital (net)</u>
1983	\$31,454	\$145,468	\$114,014	\$-9,106	\$20,799	\$-17,700
1984	44,257	168,290	124,033	-7,747	35,003	-49,651
1985	55,986	174,015	118,029	-5,165	49,169	-64,542
1986	92,827	205,591	112,764	-4,932	85,845	-131,461
1987	96,386	224,605	128,219	-5,702	87,015	-136,532
1986:I	14,552	44,813	30,261	-1,145	12,668	-18,990
1986:II	23,922	52,270	28,348	-374	23,099	-28,882
1986:III	26,793	53,859	27,066	-1,922	24,413	-38,410
1986:IV	27,560	54,649	27,089	-1,491	25,665	-45,179
1987:I	23,373	50,515	27,142	-1,348	20,962	-32,209
1987:II	25,038	55,823	30,785	-1,601	22,762	-44,365
1987:III	23,585	56,600	33,015	-1,757	21,189	-22,023
1987:IV	24,390	61,667	37,277	-996	22,102	-37,935
1988:I	21,021	59,345	38,324	-1,337	18,421	-15,142
1988:II (p)	22,471	63,409	40,938	-2,133	19,333	-36,353

Table 2: Japan's Net Purchases of Foreign Securities

(in millions of dollars)

	<u>Bonds</u>			<u>Stocks</u>		
	<u>Purchases</u>	<u>Sales</u>	<u>Net</u>	<u>Purchases</u>	<u>Sales</u>	<u>Net</u>
1983	\$22,905	\$10,400	\$12,505	\$2,106	\$1,445	\$661
1984	56,348	29,575	26,773	1,570	1,519	51
1985	291,338	237,859	53,479	5,484	4,489	995
1986	1,346,989	1,253,965	93,024	20,917	13,869	7,048
1987	1,273,829	1,200,944	72,885	70,936	54,062	16,874
1986:I	251,591	234,330	17,261	2,793	1,961	832
1986:II	368,271	343,467	24,804	3,717	2,260	1,457
1986:III	357,331	330,980	26,351	6,481	4,473	2,008
1986:IV	369,796	345,188	24,608	7,926	5,175	2,751
1987:I	377,850	354,648	23,202	13,925	9,386	4,539
1987:II	341,880	316,585	25,295	15,277	9,797	5,480
1987:III	325,517	308,421	17,096	21,882	18,370	3,512
1987:IV	228,582	221,290	7,292	19,852	16,509	3,343
1988:I	332,047	318,877	13,170	18,901	19,467	-566
1988:II (p)	401,293	374,371	26,922	20,518	20,643	-125

Figuring out what will happen to Japanese portfolio investment abroad is harder. Purchases of foreign government and corporate bonds -- mainly American instruments, brokers believe -- hit a new quarterly high in the April-June period (see Table 2), thanks in large part to the dollar's stability. Japanese investors also unloaded an unprecedented amount of foreign fixed-income securities in the quarter, but the net figure still was a record. That record could be short-lived if the dollar continues to look strong over the short run and U.S. interest rates firm following the Federal Reserve Board's August 9 hike in the discount rate.

Susan MacKnight

Takeshita Prepares For China

The tenth anniversary of the China-Japan Peace and Friendship Treaty will provide a backdrop for Prime Minister Noboru Takeshita's August 25-30 trip to China. The planned celebration will not mask the handful of contentious issues Mr. Takeshita must address. The bilateral situation is hardly dire, however, and both sides can point to positive developments.

The bilateral trade balance threatens to resurface as an issue as it has swung back in Japan's favor. While Japan ran up a \$497.7 million trade deficit with China over the first six months of 1987, it has accumulated a \$643.5 million surplus in the same period this year (see Table). The turnaround is due to an expansion in exports and a reduction in imports, although the change is hidden in the dollar-denominated data by the sharp appreciation of the yen. When viewed in yen terms, exports rose 13.9 percent to Y589.1 billion in the first half of 1988; concurrently, imports from China fell 16.7 percent to Y483 billion. Whatever the currency, however, the total volume of bilateral trade declined -- by 2.3 percent in yen terms and 16.3 percent on a dollar basis.

Japan's Trade with China, January-June 1987 and 1988

a. in thousands of dollars

Year	Exports		Imports		Total	
	Value	Change	Value	Change	Value	Change
1987	\$4,088,488	-13.8%	\$4,586,210	16.1%	\$8,674,698	-2.3%
1988	3,953,126	-3.3	3,309,657	-27.8	7,262,783	-16.3

b. in millions of yen

1987	Y517,382	-29.1%	Y579,613	-7.5%	Y1,096,995	-20.8%
1988	- 589,107	13.9	482,984	-16.7	1,072,091	-2.3

Source: Ministry of Finance

China remains unhappy about access to the Japanese market and claims that exports of textiles and other light manufactures have been actively impeded by Tokyo. Japanese export restrictions to stop the outflow of militarily

sensitive products and technology to communist countries also irritate Beijing, although Tokyo is moving to expand its list of permissible exports and streamline export approval procedures. In an overall sense, both sides are unhappy that total bilateral trade has fallen since both nations' global trade volumes are up. Harmonious trade relations allow other issues to be addressed; trade frictions complicate apparently simple issues.

The continuing disagreement over the ownership of a student dormitory in Japan is an example. The government on Taiwan, which bought the facility in 1952, tried to evict eight mainland Chinese residents in the mid-1970s, initiating a legal dispute between Taiwan and China in the Japanese courts. After the Osaka high court's February 26, 1987 affirmation of a 1977 lower court ruling in favor of Taiwan, Beijing protested directly to Tokyo, calling the decision a violation of the 1972 Sino-Japan joint communique normalizing relations and the 1978 peace and friendship treaty. Tokyo pleaded that it could not force the court to rescind its ruling due to the constitutional separation of powers. This, from Japan's viewpoint, was the end of the matter. In an August 4 article in a Chinese journal distributed overseas, however, a Chinese scholar blasted this reasoning as a "pretext," and claimed that Tokyo had effectively adopted a "two Chinas" or "one China, one Taiwan" policy. Coming just before Mr. Takeshita's visit, the article is interpreted as a warning that the issue will be raised during the trip.

Another political issue that almost surely will be raised is the continuing disagreement over whether Japanese cabinet ministers should make an official visit to the Yasukuni shrine commemorating Japanese war dead. Eight war criminals are among the thousands memorialized at the Yasukuni shrine. Former Prime Minister Yasuhiro Nakasone was strongly criticized by China and other Asian nations when he officially paid his respects there in 1985. Mr. Nakasone did not repeat his official visit, a stance adopted by Mr. Takeshita. However, the deputy prime minister, Kiichi Miyazawa, and at least seven other cabinet ministers have announced that they will pay homage at Yasukuni as private citizens during this year's August 15 services commemorating the Japanese surrender. That Mr. Takeshita will allow this and that he failed to quickly disown intemperate remarks by his former Land Agency director general about the Sino-Japanese war (see JEI Report No. 20B, May 20, 1988) does not sit well with Chinese officials. Their unhappiness will surely be made known to the prime minister.

On the brighter side, Mr. Takeshita will bring with him a massive new aid package for his hosts. Beijing had proposed a package of Y916.5 billion (\$7.4 billion at Y125=\$1.00) for 55 projects for the FY 1991-FY 1995 period. After months of talks, Tokyo will extend approximately Y800 billion (\$6.4 billion) for some 40 projects. This is the largest yen-loan program yet; Y200 billion (\$1.6 billion) was lent in the FY 1980-FY 1983 period and another Y470 billion (\$3.8 billion) is earmarked for the FY 1984-FY 1990 time frame. Although some of the projects will be carryovers from the current program, a number of new ones have been added, including transportation modernization and the development of Hainan island.

In addition, the Foreign Ministry announced July 26 that a Y191.5 billion (\$1.5 billion) line of credit will be arranged during the current fiscal year for Chinese modernization projects. The loans are a component of Prime

Minister Nakasone's \$30 billion plan to recycle Japan's external surplus to developing countries. The Overseas Economic Cooperation Fund will provide two yen loans of ¥91.5 billion (\$732 million) and ¥70 billion (\$560 million); the Export-Import Bank of Japan will provide the remaining ¥30 billion (\$240 million) in bank loans. The OECF loans are repayable in 30 years (including a 10-year grace period) at an interest rate of 2.5 percent. The new packages will confirm China's place as the largest recipient of Japanese aid.

Tokyo is also urging private businesses to increase their direct investment in China, and Beijing is taking steps to improve the investment climate. Although Japanese direct investment jumped to \$1,226 million in FY 1987 from \$226 million in the previous fiscal year, Japan accounts for only 8.7 percent of total foreign direct investment in China (as of the end of 1987). Moreover, investment in non-oil areas was stagnant in 1987. Embarrassed by the reluctance of Japanese businessmen, Tokyo has been holding investment promotion tours, touting China's lower costs (in comparison to Taiwan and South Korea) and even encouraging medium- and small-sized firms to consider taking the plunge. Beijing has just announced that it will accord Japanese investment projects national treatment, putting them on a equal basis with purely domestic firms. While at least 20 other nations have agreements with Beijing to protect their investments, only Japan has been given this special treatment. To insure that implementation proceeds smoothly, a joint committee will be formed to oversee its operation. This special status will be included in an accord to be signed during Mr. Takeshita's visit.

Both Chinese and Japanese officials are eagerly awaiting the prime minister's trip. While the majority of the visit will undoubtedly be friendly, Mr. Takeshita is aware that his Chinese hosts have some serious concerns.

Jon Choy

Trade Bill Sent To President

Passage of the more than 1,000-page omnibus trade bill marks what many analysts are calling the largest revision of U.S. trade policy since the end of World War II. Designed to strengthen the U.S. economy and to combat unfair foreign trade practices, the trade bill (HR 4848) was approved by the Senate August 3 by an overwhelming vote of 85-11. The House had passed the bill in mid-July by a margin of 376-45. President Reagan has said that he will sign the bill into law even though he vetoed a similar version of the bill (HR 3) earlier this year (see JEI Report No. 21B, May 27, 1988).

Japanese government officials and business leaders have expressed concerns over the bill because they fear it could adversely impact free trade. After passage of the bill, Tokyo reserved the right to take the United States to the General Agreement on Tariffs and Trade to determine whether the legislation violates the international trade organization's multilateral trade principles. In particular, government and industry worry about the bill's retaliatory provisions.

Several aspects of the trade bill specifically affect Japan. First there are the sanctions against Toshiba Machine Co., Ltd. and parent Toshiba Corp.

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J A P A N · E C O N O M I C · I N S T I T U T E

JEI

R E P O R T

A Two-Part Report: A and B

NO. 33A

August 26, 1988

U.S. EXPORTS TO JAPAN: A REVIEW OF 1987 SALES

Summary

The weaker dollar did what it was supposed to do for 1987 Japan-bound U.S. exports. Saying that is not repeating the obvious since on paper sales to this country's second-biggest foreign customer were up by a paltry 5.1 percent to \$28.3 billion. Shipments actually jumped 18.1 percent, but this robust performance, which was largely duplicated in volume terms, got lost in the trade results because the 1986 export total was inflated by a \$3.1 billion transshipment of foreign bullion through the United States to Japan.

While giving a big push to exports, the dollar's 53 percent drop against the yen between February 1985 and yearend 1987 could not do the job alone. Brisk Japanese demand, buoyed by a spurt in residential construction as well as higher consumer spending and stepped-up business investment, exerted a simultaneous pull on exports, multiplying the gains for American suppliers. At the same time, U.S. producers generally were positioned to capitalize on new market opportunities, having been forced by the strong dollar in the first half of the 1980s to slash costs, improve quality and become more aggressive marketers.

Although the new dollar-yen relationship gave exporters a major boost, they still had problems. For one thing, American companies did not gain competitive ground in the Japanese market against Australian, Canadian, Korean and other Pacific Rim rivals whose currencies move in synch with the dollar or are weaker. Then, too, while many U.S. exporters held the line on prices or just raised them by small amounts, some suppliers put fatter profit margins ahead of market share considerations. On the other hand, part of the benefit of lower yen prices for American-made

products was absorbed by Japanese importers or distributors. Supply availability also was a problem in a few product lines because of strong demand here.

For most U.S. exporters, however, these constraints were no match for the push and pull of the weaker dollar and the strength of Japanese demand. Sales of industrial inputs and intermediate products advanced 16 percent to just below \$10.2 billion, a new record, while exports of food and feed moved closer to their 1984 high with a 10.2 percent gain to almost \$5.6 billion. Even more striking were the 15.5 percent jump in capital goods shipments to \$7.8 billion and the 50.9 percent surge in consumer goods exports to nearly \$2.6 billion.

Industrial Supplies

The 1980s have been a difficult, frequently frustrating time for American suppliers of many big-ticket industrial raw materials and intermediate inputs. Despite higher Japanese industrial production, U.S. exports have seesawed between limited gains one year and small losses the next. Last year was different. But just like the strong dollar had little to do with the checkered performance of sales in the first half of the decade, the weaker dollar deserved only partial credit for 1987's big export increase. The reason was simple. With the currencies of most competitors for Japan's import business linked at least loosely to the dollar, the dollar's fall did not give American producers a price advantage. Expanding sales in the Japanese market last year was largely a matter of targeting niches of strong demand and/or short supplies. The winner was the country that came out on top in terms of relative production and transportation costs, although product availability sometimes determined the ranking.

Logs and Lumber - Japanese residential construction activity in 1987 was at its highest level since 1973, thanks to a postwar low in conventional mortgage rates and an expanded government program of below-market financing. At nearly 1.7 million units, housing starts were 22.7 percent above 1986's total and 40.9 percent greater than the average for the 1980-85 period. Additional work for contractors, though, does not necessarily mean more business for sawmills, domestic or foreign, or Pacific Northwest softwood log exporters. What counts for mill operators is the number of wood houses built and their floor space, and for the first time in the 1980s both numbers were up significantly. The key figures for American log suppliers -- comparative international prices and the price spread between U.S. logs and Japanese ones -- also signaled bigger sales.

Pacific Northwest softwood log prices increased by a sizable margin in 1987, but the dollar's lower value still enabled exporters to undercut Soviet shippers, their chief rivals in Japan's imported softwood log market. In fact,

American companies not only won a large part of the extra import volume generated by the housing boom but also rolled back the Soviet market share. At the same time, bargain prices on American softwood logs led Japanese sawmills to shift more of their business from domestic suppliers, normally the source of roughly one-half of the country's lumber, to the United States. This switch did not cut into U.S. softwood lumber shipments. On the contrary, exports reached a new high, in part because 2x4 construction methods, which are based on lumber milled to North American specifications, were used to build a record 40,000 units in 1987. This bonus plus gains in both hardwood log and lumber exports boosted U.S. wood sales 43.4 percent to \$1.6 billion.

Paper Base Stocks - Higher-than-expected Japanese production of paper and especially paperboard products in 1987 helped U.S. exporters of paper base stocks keep sales on the upswing. So did the industry's continuing efforts to minimize its international cost handicap. That campaign produced another increase in the use of waste paper and paperboard -- a big plus for American recycling centers. It also led to the substitution of American and Australian wood chips for the domestic product since imported chips were as much as 30 percent cheaper. In reality, Japan's paper and paperboard mills had little choice. Tight world supplies made expanded purchases of imported paper pulp uneconomical, even after factoring in the benefits of the weaker dollar. Ironically, though, the run-up in U.S. pulp prices was the main reason exports of paper base stocks increased 32.6 percent last year to almost \$0.8 billion.

Chemicals - Japan's petrochemical industry, on the critical list five years ago, operated at or near capacity in 1987. The low price of naphtha, the industry's dominant feedstock and fuel, continued to give manufacturers of both ethylene -- the basic building block for such intermediates as ethylene dichloride, propylene and acrylonitrile -- and benzene -- the raw material for derivatives like styrene monomer -- help on the cost front. The biggest difference between 1986 and last year, though, was Japanese demand for downstream products, particularly plastic materials. Demand, in fact, was strong enough to create periodic shortages of some commodity intermediates. This provided a wider opening for lower-cost American petrochemical producers, but they were unable to exploit this opportunity completely because capacity limitations and higher product demand had also led to tightening U.S. supplies.

U.S. suppliers of industrial inorganic chemicals also had trouble capitalizing fully on their cost advantage in commodity products like soda ash, sulfuric acid and industrial gases. The constraint here was not on the supply side. Instead, it was the uneven performance of the diverse Japanese end markets for these products -- housing, paper and pulp, automotive products, glass, fertilizers, detergents and other chemicals. With export gains in industrial inorganic chemicals limited at best and shipments off in the big-ticket category of uranium and thorium compounds for use in medical research and diagnostic procedures, sales of chemicals increased by a modest 7.7 percent to \$1.9 billion despite higher-priced petrochemical exports.

Petroleum Products - West Coast oil refiners have become adept niche players in the Japanese market, using their surplus stocks of petroleum products to cover shortages caused by the long-term decline in Japanese production. For example, a persistent mismatch between supplies of heavy (residual) fuel oil and demand for this product for specialized uses, including bunker fuel for

coastal shipping, has generated a growing business for American and other exporters. West Coast suppliers, however, lost more of their heavy fuel oil sales last year to refineries in Southeast Asia because of a significant rise in U.S. prices. Shipments of light (distillate) fuel oil were off as well. On the other hand, Tokyo's January 1986 decision to lift the controls on imports of gasoline and kerosene continued to pay off for U.S. producers. On balance, therefore, sales of petroleum products advanced 16.5 percent in 1987 to almost \$0.7 billion.

Food and Feed

The continuing fall in the dollar's value gave another boost to exports of fish, meat, fruits and vegetables and value-added food products in 1987. The bottom line in the food and feed category, however, is determined by what happens to two big-ticket bulk commodities, corn and soybeans, and that depends on a long list of factors -- demand for commercially mixed livestock and poultry feed in Japan, relative ingredient costs, exportable supplies and prices in major producing countries, and the dollar's value.

Corn - The weaker dollar on top of generally lower ingredient costs allowed Japan's formula feed industry to extend the string of price cuts that started in the April-June 1984 period through last year's four quarters. That kept demand on the upswing despite more pressure on the prices received by producers of broiler meat, eggs and milk. Compound feed production, in turn, went up for the sixth straight year. Unlike the gains of 1984 to 1986, this increase translated into added business for the world's corn exporters -- substantially more since corn not only supplied all of the extra volume needed to raise output but also displaced a large amount of relatively high-priced sorghum, the main beneficiary of the 1984-86 production rise.

The big question was which country would supply Japan's additional corn requirements, and here hard-pressed U.S. exporters, which had lost considerable sales in 1986 to Chinese and Argentine competitors, got a break. With smaller exportable supplies available in China and a below-average crop in Argentina, Japanese importers returned to the American market for a near-record volume of corn for formula feed use. U.S. corn suppliers actually benefited from a double windfall last year since predictions of a limited crop in South Africa, Japan's preferred supplier of corn to manufacture sweeteners and starch, led the trade to increase commitments for American corn. This bonus helped to lift shipments by two-fifths and even though export prices were down again, sales advanced 18 percent to \$1 billion.

Soybeans - Increased Japanese production of commercially mixed feed in 1987 was no help to U.S. soybean exporters. Carryover stocks of soybean meal were above average because oilseed processors had not reduced the soybean crush enough in 1986 as relative vegetable protein meal prices moved in favor of greater rapeseed meal usage in formula feed. With rapeseed meal retaining its price edge last year and demand for vegetable oil fairly flat, the processing industry trimmed the soybean crush and expanded rapeseed crushing to meet oil demand while working down soybean meal stocks. This adjustment alone would have produced a cutback in soybean purchases from the United States, but importers also had overbought American soybeans in 1986. To make matters worse, the trade contracted for more soybeans from Brazil, which in 1985 broke this country's

monopoly on providing all the soybeans crushed by Japanese oilseed processors. The net result was a 6.4 percent drop in exports to under \$0.8 billion.

Capital Goods

The true test of the marketing power of the weaker dollar, most analysts would argue, is the export performance of capital goods. Going by 1987's record \$1 billion jump in sales (excluding volatile aerospace exports) and the single-digit increase in business investment in Japan, the dollar's fall unquestionably helped U.S. manufacturers of computers, measuring and testing instruments, medical equipment and a long list of other technology-intensive products to win battles with Japanese competitors on their home turf. At the same time, the factors shaping Japanese capital spending last year -- the manufacturing sector's ongoing attempt to cope with the strong yen through greater automation, diversification and development of new product and process technologies and the nonmanufacturing sector's need to expand and upgrade its computer and communications capabilities -- played to the competitive strengths of American machinery and equipment makers.

Computers - U.S. systems manufacturers have spent most of the 1980s defending their market position in Japan from further erosion by an expanding lineup of domestic challengers. By facilitating aggressive discounting, however, the declining dollar allowed American vendors to go on the offensive. This strategy worked in 1987, fragmentary information suggests, although suppliers got some help from the first significant increase in three years in corporate budgets for computer hardware expenditures.

For example, IBM Japan Ltd., after stumbling in 1986 while competitors Fujitsu, Ltd., NEC Corp. and Hitachi, Ltd. posted double-digit gains in home-market sales, boosted domestic revenues 15.6 percent to Y743.4 billion (\$5.1 billion at 1987's average exchange rate of Y144.64=\$1.00). A major part of this growth came in IBM's stronghold -- mainframes, particularly the 3090 series of large-capacity systems. But the computer giant also made gains in the market for midrange computers or what the Japanese call small business systems. So, apparently, did U.S. minicomputer industry leader Digital Equipment Corp. Where DEC and other American midrange computer makers did best, however, was in the market for superminicomputers and engineering workstations. On the other hand, U.S. producers of personal computers were stymied again in their attempt to break NEC's stranglehold on the expanding Japanese market for 16-bit units.

Changes in IBM Japan's sales are only partly reflected in the export statistics for computers and peripheral equipment since an estimated 70 percent of the products it sells in Japan are made there. Even so, the 22.7 percent increase in hardware exports to \$1 billion gives additional weight to the assumption that U.S. manufacturers improved their Japanese market position in 1987. At the same time, IBM Japan's better performance showed up indirectly in the figures for parts, which jumped 32.6 percent to \$0.8 billion.

Commercial Aircraft - Aircraft sales were off in 1987 as Japanese airlines took delivery of 16 planes -- one less than the year before, but this trade still was a \$1 billion business. Japan Air Lines added two of Boeing Co.'s 747-300s to its fleet of jumbo jets -- one for international passenger service and the other for domestic routes -- plus a 747-200 freighter. It also

took delivery of two 767-300s for international use and three for service in Japan. For its part, All Nippon Airways acquired another 747-200 to facilitate the expansion of international flights, while adding six 767s, including its first four 767-300s, to handle passenger traffic in Japan. Moreover, McDonnell Douglas Corp. delivered an MD-81 to Japan Air System (formerly Toa Domestic Airlines), the number-three Japanese carrier.

Consumer Goods

If the big gain in capital goods sales was not sufficient proof of the competitive benefits of the weaker dollar for exporters of manufactured products, then the 51 percent jump in consumer goods sales certainly was. Luxury goods -- diamonds, jewelry, artworks -- admittedly accounted for a significant part of this advance. The export results also were skewed by surging sales of cigarettes, which profited not only from the lower dollar but also from April 1987 changes in Japan's restrictive cigarette pricing policies. Still, substantial sales increases were posted in a cross section of other consumer durables and nondurables.

Pharmaceuticals - On paper pharmaceuticals seemed to be the major exception in the consumer goods category since exports were up by a modest 8 percent to \$0.7 billion. This outcome, however, was almost entirely the result of an AIDS-related cutback in the big trade in blood products. Otherwise, American drug companies successfully capitalized in 1987 on the first significant expansion in pharmaceutical sales in Japan in five years. The common strategy for dealing with the fallout from the five rounds of cuts in official drug prices instituted by the Ministry of Health and Welfare in the 1980s involved targeting emerging growth markets where U.S. pharmaceutical houses are ahead of their Japanese competitors -- cardiovascular drugs and diagnostic testing, for example, while continuing to fight for sales of antibiotics, the mainstay of Japan's top manufacturers.

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The views expressed in this report are those of the author and do not necessarily represent those of the Japan Economic Institute.

U.S. Exports to Japan by Commodity, 1986 and 1987

(in millions of dollars and indicated quantity units)

Commodity	Quantity		Value		Percent Change 1986/87	Japan's Share of U.S. Exports 1987
	1986	1987	1986	1987		
<u>Total Exports</u>			<u>\$26,881.6</u>	<u>\$28,248.6</u>	<u>5.1%</u>	<u>11.2%</u>
<u>Industrial Supplies</u>						
<u>Logs and Lumber</u>						
Logs	2,958,691 mbf	3,621,057 mbf	8,751.5	10,155.7	16.0	15.3
Douglas-fir Logs	2,076,718 mbf	2,397,115 mbf	1,097.4	1,573.4	43.4	52.3
Spruce Logs	1,216,461 mbf	1,386,987 mbf	788.9	1,127.6	42.9	68.0
Western Hemlock Logs	121,935 mbf	163,634 mbf	451.0	617.9	37.0	81.3
Lumber	621,822 mbf	705,863 mbf	70.3	106.0	50.8	64.1
Rough Hemlock Lumber	881,973 mbf	1,223,942 mbf	198.8	297.9	49.8	62.4
Dressed Hemlock Lumber	193,631 mbf	211,772 mbf	308.5	445.8	44.5	33.0
Dressed Douglas-fir Lumber	308,743 mbf	394,751 mbf	55.2	69.2	25.4	88.1
Paper Base Stocks	88,724 mbf	103,824 mbf	96.9	130.8	35.0	92.2
Wood Chips			28.1	34.7	23.5	53.7
Wood Pulp	2,115,988 stn	2,481,142 stn	563.8	747.8	32.6	24.7
Waste Paper and Paperboard	948,591 stn	977,233 stn	154.3	184.3	19.4	97.8
Paper and Paper Products	399,064 stn	659,911 stn	359.3	470.3	30.9	21.0
Newsprint			47.2	93.0	97.0	16.8
Kraft Linerboard	194,127 stn	200,314 stn	354.0	398.8	12.7	13.2
Coated Container Base Stock	166,110 stn	167,093 stn	123.2	148.6	20.6	70.7
Bituminous Coal	143,604 stn	150,984 stn	50.1	57.3	14.4	7.1
Coking Coal	11,369,424 stn	10,597,276 stn	102.7	109.3	6.4	49.3
Steam Coal	10,478,546 stn	9,626,567 stn	544.7	484.5	-11.1	14.6
Petroleum Products	890,878 stn	970,709 stn	518.9	448.1	-13.6	19.8
Gasoline			35.8	36.4	1.7	3.5
Jet Fuel (kerosene type)	4,539,690 bbl	5,607,788 bbl	567.7	661.3	16.5	17.4
Light Fuel Oils	1,396,427 bbl	2,624,526 bbl	79.0	126.7	60.4	43.4
Heavy Fuel Oils	5,720,741 bbl	5,388,904 bbl	33.4	56.2	68.3	25.7
Lubricating Oils	9,315,609 bbl	8,363,866 bbl	115.4	105.5	-8.6	25.0
Petroleum Coke (excl. calcined)			132.1	143.3	8.5	13.7
Natural Gas	3,440,614 stn	3,840,515 stn	27.9	35.6	27.6	5.9
Nuclear Reactor Fuels	52,670,591 mcf	49,475,098 mcf	119.2	128.0	7.4	32.2
Chemicals (excl. plastics, fertilizers and insecticides)			187.0	144.3	-22.8	99.7
Acyclic Hydrocarbons			28.7	4.2	-85.4	3.2
Cyclic Hydrocarbons			1,726.4	1,859.0	7.7	14.2
Para-xylene			26.8	19.9	-25.7	6.8
Cyclic Organic Compounds	28,415,688 gal	17,463,016 gal	57.1	65.4	14.5	8.7
Toluene			39.9	20.6	-48.4	15.6
Cyclic Organic Intermediate Chemical Compounds	2,090 gal	35,638,695 gal	2.3	43.6	1,795.7	18.9
Alcohols, Phenols and Their Derivatives			0.1	28.7	28,600.0	25.6
Nitrogen Function Compounds and Their Derivatives			159.9	180.6	12.9	11.0
Acyclic Organic Chemical Products	26,436 stn	28,082 stn	67.3	62.1	-7.7	25.0
Ethylene Dichloride			31.1	33.2	6.8	16.5
Acrylonitrile	162,392 stn	177,257 stn	346.3	414.7	19.8	13.7
Vinyl Acetate Monomer	102,145 stn	106,695 stn	32.0	39.8	24.4	37.2
Plasticizers and Rubber-Processing Chemicals	57,582 stn	56,258 stn	49.7	62.9	26.6	18.6
			22.3	27.4	22.9	15.4
			19.5	28.9	48.2	12.8

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Commodity	Quantity		Value		Percent Change 1986/87	Japan's Share of U.S. Exports 1987
	1986	1987	1986	1987		
Uranium and Thorium Compounds	798 stn	712 stn	\$600.2	\$520.2	-13.3%	59.4%
Sodium Compounds			53.4	59.7	11.8	7.6
Soda Ash	235,465 stn	247,013 stn	26.6	31.8	19.5	12.8
Pigments			29.7	37.8	27.3	13.2
Color Lakes and Toners, Dyes and Paints			40.5	43.8	8.1	7.2
Synthetic Detergents			19.3	43.0	122.8	41.4
Antiknock Compounds and Additives for Lubricating Oils			58.6	61.5	4.9	7.6
Laboratory Reagent Preparations			31.7	33.4	5.4	17.2
Fertilizers and Fertilizer Materials			99.1	152.7	57.1	6.8
Unmixed Pesticides			80.6	68.4	-15.1	9.3
Manufactured Pesticides			66.7	77.0	15.4	10.5
Plastic and Synthetic Resin Compounds			322.0	403.9	25.4	8.0
Polycarbonate Resins	9,987 stn	18,714 stn	22.3	43.3	94.2	26.3
Film, Strips and Sheets			54.5	66.5	22.0	8.4
Synthetic Rubber			65.8	64.9	-1.4	8.5
Still X-Ray Film	63,066,347 sft	70,385,911 sft	49.6	55.1	11.1	34.4
Graphic Arts Film	69,118,972 sft	76,143,885 sft	31.0	32.5	4.8	24.5
Still Photographic Film (excl. film packaged for retail sale)	24,933,414 sft	25,381,361 sft	41.6	42.5	2.2	15.2
Photosensitive Papers			33.3	31.1	-6.6	9.3
Steel Scrap	1,725,068 stn	985,689 stn	170.0	123.1	-27.6	12.7
Nonferrous Ores and Scrap			491.8	553.9	12.6	29.9
Copper Ore	145,104 stn	109,737 stn	141.3	122.1	-13.6	77.8
Copper Scrap	42,154 stn	43,640 stn	43.7	54.7	25.2	18.1
Aluminum Scrap	264,115 stn	290,235 stn	223.8	300.9	34.5	73.4
Silver	4,211,631 toz	5,567,683 toz	23.1	37.2	61.0	39.1
Platinum and Platinum Group Metals	108,312 toz	120,748 toz	29.9	41.4	38.5	29.5
Copper and Copper Alloys			8.3	26.6	220.5	7.7
Aluminum and Aluminum Alloys			188.4	358.2	90.1	29.8
Aluminum Ingot	144,849 stn	250,097 stn	161.7	310.6	92.1	74.9
Aluminum Plates, Sheets and Strip	4,590 stn	9,602 stn	14.4	29.8	106.9	5.4
Unwrought Magnesium	9,926 stn	9,671 stn	25.8	23.6	-8.5	21.3
Wrought Zirconium	364 stn	399 stn	20.0	25.1	25.5	44.3
Gold	569,906 toz	16,945 toz	243.9	4.7	-98.1	0.2
Steel (incl. ferroalloys)			51.7	47.1	-8.9	3.6
Silicon			33.2	55.0	65.7	51.8
Unmanufactured Nonmetallic Minerals			111.5	133.2	19.5	16.2
Kaolin Clay	455,408 stn	561,494 stn	65.3	84.0	28.6	24.7
Other Clays			27.2	25.2	-7.4	19.3
Manufactured Mineral Supplies			128.0	146.3	14.3	9.2
Glass (excl. automotive and mirror glass)			36.0	41.5	15.3	9.5
Industrial Textile Fibers, Yarns and Fabrics			74.1	112.4	51.7	3.8
Manmade-Fiber Yarns	7,583 stn	9,455 stn	22.4	29.0	29.5	5.8
Raw Cotton	784,735 rba	1,328,326 rba	238.6	413.7	73.4	25.4
Hides and Skins			331.4	369.6	11.5	25.5
Whole Cattle Hides	6,624,385 pc	5,929,002 pc	302.2	332.6	10.1	25.5
Leaf Tobacco	40,736 stn	52,686 stn	227.1	300.8	32.5	27.6
Stemmed Flue-Cured Leaf	22,192 stn	32,861 stn	148.4	217.6	46.6	36.5
Stemmed Burley Leaf	12,681 stn	15,953 stn	74.5	78.0	5.0	31.2
Capital Goods			6,727.5	7,769.0	15.5	6.9
Nonelectric Machinery			3,561.7	4,231.1	18.8	8.2

Commodity	Quantity		Value		Percent Change 1986/87	Japan's Share of U.S. Exports 1987
	1986	1987	1986	1987		
Data Processing Equipment			\$1,400.6	\$1,777.1	26.9%	9.6%
Computers			404.2	498.5	23.3	12.2
Peripheral Equipment and Parts			897.1	1,127.9	25.7	8.4
Disk and Tape Storage Units			104.1	127.9	22.9	9.0
Terminals			40.5	54.4	34.3	5.2
Parts			592.7	786.2	32.6	8.9
Magnetic Computer Disks and Tapes and Computer Programs			79.8	99.9	25.2	11.7
Semiconductor Production and Assembly Equipment and Parts			155.8	125.5	-19.5	16.6
Measuring, Testing and Controlling Instruments and Parts			581.1	699.8	20.4	13.1
Industrial Process-Type Instruments and Parts			40.4	49.8	23.3	7.2
Chemical Analysis Equipment and Parts			56.3	81.6	44.9	12.7
Physical Analysis Equipment and Parts			52.7	72.7	38.0	14.4
Equipment for Testing Electrical, Radio and Communications Circuits and Parts			258.0	318.3	23.4	20.7
Waveform Measuring and/or Analyzing Apparatus and Parts			42.3	47.7	12.8	17.0
Instruments for Measuring or Testing Combinations of Electrical Characteristics and Parts			132.4	164.1	23.9	26.4
Instruments for Measuring or Checking Electrical Quantities and Parts			25.5	25.6	0.4	13.8
Scientific, Professional and Medical Equipment			337.0	433.6	28.7	15.0
Electromedical and Electrotherapeutic Apparatus and Parts (excl. X-ray apparatus)			149.9	207.5	38.4	16.9
Medical Equipment Based on X-Rays and Parts			43.8	54.0	23.3	21.1
Other Medical, Dental and Surgical Instruments and Parts			116.8	139.5	19.4	12.5
Bougies, Catheters, Drains and Sondes and Parts			38.6	50.2	30.1	19.3
Power Generating Equipment (excl. aircraft and automotive engines)			77.1	108.6	40.9	5.6
Gas Turbines and Parts for Mechanical Drives			21.5	37.3	72.7	8.2
Nonfarm Tractors, Parts and Attachments			63.4	78.0	23.0	5.2
Parts of Tracklaying Tractors			39.3	36.4	-7.4	8.2
Excavating and Paving Machinery and Parts			33.5	37.0	10.4	2.5
Drilling and Oilfield Equipment			62.3	14.4	-76.9	0.8
Parts and Accessories for Oilfield and Gasfield Drilling Equipment			55.7	11.3	-79.7	0.8
Machinery and Parts for Making or Finishing Pulp, Paper and Paperboard			28.9	20.4	-29.4	6.7
Machine Tools and Parts			83.3	74.8	-10.2	7.6
Parts			31.5	20.7	-34.3	5.8
Commercial and Industrial Heating and Cooling Equipment and Parts			42.9	51.7	20.5	6.0
Pumps and Compressors			51.6	55.7	8.0	8.2
Filtering and Purifying Machinery and Parts			44.7	59.7	33.6	11.6
Taps, Cocks, Valves and Similar Devices and Parts			37.1	49.3	32.9	7.0
Equipment for Service Industries			143.7	196.1	36.5	7.9
Still Camera Parts			19.5	25.2	29.2	19.3
Magnetic Recording Media (not recorded)			19.2	25.1	30.7	7.9
Electric Machinery			977.5	1,218.6	24.7	6.9
Semiconductors			294.3	469.7	59.6	7.6
Discrete Devices and Parts			40.9	72.4	77.0	6.2
Parts			18.5	51.4	177.8	6.3
Integrated Circuits			144.6	234.3	62.0	14.4

Commodity	Quantity		Value		Percent Change 1986/87	Japan's Share of U.S. Exports 1987
	1986	1987	1986	1987		
Linear Integrated Circuits			\$28.6	\$34.0	18.9%	13.1%
Digital Bipolar Logic Integrated Circuits			30.9	30.0	-2.9	12.1
Digital MOS Microprocessors			21.3	41.3	93.9	17.2
Chips, Dice and Wafers			107.0	163.0	52.3	4.7
Printed Circuit Boards	1,049,327 no	1,196,805 no	22.4	27.6	23.2	5.0
Electronic Tubes (excl. television picture tubes)			32.1	29.1	-6.2	12.1
Telephone Equipment and Parts			72.3	62.5	-13.6	7.8
Microphones, Loudspeakers and Amplifiers and Parts			23.7	30.7	29.5	12.5
Radar Apparatus (excl. for planes and boats) and Parts			92.2	154.3	67.4	21.0
Generators, Transformers and Accessories			84.9	128.3	51.1	20.7
Switches and Relays			73.7	68.3	-7.3	4.3
Connectors			30.4	26.6	-12.5	7.7
Transportation Equipment			45.1	50.4	11.8	10.3
Civilian Aircraft			2,188.3	2,319.3	6.0	5.5
Passenger, Cargo and Combination Jet Transports	17 no	16 no	1,161.3	1,094.9	-5.7	14.6
Helicopters (2,000 pounds and over)	9 no	32 no	1,130.3	1,028.1	-9.0	16.1
Civilian Aircraft Engines, Parts and Accessories			10.2	34.2	235.3	19.7
Jet Turbines			659.6	753.6	14.3	9.1
Jet Engine Parts			37.9	42.7	12.7	3.6
Parts for Civilian Aircraft			230.3	251.2	9.1	11.6
New Cars	2,759 no	4,721 no	350.1	409.3	16.9	9.7
Automotive Parts, Engines and Bodies			42.4	72.3	70.5	1.1
Tires and Tubes			235.0	274.4	16.8	1.9
Parts for Ships and Boats			20.7	60.2	190.8	16.2
			4.6	26.8	482.6	7.9
Food and Feed						
Corn (excl. seed and popcorn)	361,006,823 bu	505,781,408 bu	5,042.8	5,555.1	10.2	23.1
Sorghum (excl. seed)	84,437,152 bu	92,610,981 bu	866.0	1,022.0	18.0	31.9
Soybeans (excl. seed)	151,441,602 bu	139,477,174 bu	177.3	180.8	2.0	46.4
Animal Feeds			837.2	783.5	-6.4	18.2
Dried Beet Pulp	454,878 stn	398,477 stn	232.7	228.1	-2.0	8.5
Hay and Straw	333,623 stn	353,667 stn	55.1	44.4	-19.4	52.0
Alfalfa Hay Cubes	597,935 stn	562,187 stn	45.0	44.0	-2.2	96.1
Corn Gluten Meal	79,479 stn	108,519 stn	77.5	67.6	-12.8	95.7
Wheat	118,472,413 bu	110,190,704 bu	18.0	26.2	45.6	56.1
Fruits and Vegetables			424.3	352.3	-17.0	11.8
Lemons	135,352 stn	139,164 stn	584.0	664.5	13.8	22.5
Grapefruit	172,178 stn	222,696 stn	83.0	82.0	-1.2	88.0
Oranges and Tangerines	123,622 stn	135,353 stn	74.1	95.5	28.9	56.5
Cherries	4,337 stn	13,061 stn	68.5	79.5	16.1	35.5
Other Fresh Non-Citrus Fruit			10.6	32.9	210.4	63.2
Fruit and Vegetable Juices			39.5	48.7	23.3	12.2
Canned Corn	26,565 stn	41,986 stn	28.6	39.9	39.5	20.8
Frozen Vegetables			18.3	28.6	56.3	43.0
Frozen French Fried Potatoes	72,409 stn	88,803 stn	84.2	99.6	18.3	68.9
Almonds			45.0	57.0	26.7	83.0
Chocolate			89.7	69.4	-22.6	14.9
Meat and Meat Products			22.5	30.6	36.0	35.7
Fresh and Frozen Beef	122,334 stn	139,266 stn	760.9	898.3	18.1	50.8
Fresh and Frozen Beef Offals	53,029 stn	59,731 stn	470.7	549.9	16.8	72.8
Fresh and Frozen Pork	13,176 stn	21,511 stn	119.4	140.4	17.6	46.0
Fresh and Frozen Poultry	85,323 stn	87,332 stn	52.3	90.5	73.0	78.8
			91.2	93.6	2.6	24.4

Commodity	Quantity		Value		Percent Change 1986/87	Japan's Share of U.S. Exports 1987
	1986	1987	1986	1987		
Eggs (not in the shell)	24,922 stn	14,626 stn	\$34.6	\$27.1	-21.7%	72.8%
Fish and Fish Products			864.2	1,058.8	22.5	66.7
Fresh and Frozen Whole Salmon	108,482 stn	97,070 stn	445.6	457.2	2.6	75.7
Fresh and Frozen Whole Herring	31,907 stn	33,811 stn	46.8	59.4	26.9	72.9
Fish Roe	13,753 stn	11,882 stn	87.6	94.2	7.5	85.0
Frozen Crab	14,867 stn	23,909 stn	79.1	169.3	114.0	87.7
Consumer Goods			1,689.9	2,550.8	50.9	14.7
Pharmaceuticals			647.4	699.0	8.0	20.6
Bulk Antibiotics			196.4	250.0	27.3	31.8
Bulk Cardiovascular Drugs			51.1	56.2	10.0	21.0
Diagnostic Reagents			30.6	41.4	35.3	16.3
Blood and Blood Derivatives			170.2	109.3	-35.8	34.0
Cigarettes	481,915,900 pk	1,597,546,000 pk	128.0	491.9	284.3	24.0
Electric Household Appliances (incl. air conditioners)			41.1	43.4	5.6	3.3
Stainless Steel Cooking and Kitchenware			27.1	40.9	50.9	72.6
Records and Consumer Electronics			31.3	42.7	36.4	7.4
Records			14.4	27.5	91.0	33.2
Musical Instruments and Parts			20.6	36.6	77.7	21.5
Toys and Sporting Goods			108.9	204.3	87.6	16.9
Golf Equipment			39.2	76.4	94.9	43.3
Still Film in Cartridges and Rolls	28,535,398 no	25,896,776 no	47.2	46.6	-1.3	32.0
Floor Coverings of Textile Materials			17.4	26.7	53.4	10.8
Nonwoven Fabrics of Manmade Fibers	5,616 stn	5,258 stn	35.0	33.1	-5.4	19.0
Clothing			45.8	98.0	114.0	8.5
Footwear			36.4	50.9	39.8	27.4
Gem Diamonds and Other Gem Stones			96.3	149.2	54.9	20.2
Jewelry			33.6	49.2	46.4	17.4
Works of Art			64.3	149.6	132.7	28.8
Numismatic Coins			24.2	25.6	5.8	20.7
Printed Material			63.5	78.0	22.8	5.0
Miscellaneous			4,669.9	2,218.0	-52.5	6.5
Military-Type Goods			261.8	437.2	67.0	8.1
Other Domestic Exports			679.1	873.0	28.6	4.5
Minimum Value Shipments			102.3	203.0	98.4	3.6
All Other Domestic Exports			188.5	205.7	9.1	4.7
Parts for Aircraft and Aircraft Engines (not civilian)			388.3	464.3	19.6	15.1
Re-exports			3,729.0	907.8	-75.7	10.1
Bullion	6,755,228 toz	20,310 toz	3,095.5	9.5	-99.7	8.8

Key to quantity abbreviations: bbl = barrels mbf = thousand board feet pc = pieces sft = square feet
 bu = bushels mcf = thousand cubic feet pk = packs stn = short tons
 gal = gallons no = number rba = running bales toz = troy ounces

JEI

A Two-Part Report: A and B

NO. 33B
August 26, 1988

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EPA Releases Upbeat White Paper

By now the story is a familiar one: Japan's economy has shaken off the adverse effects of the high yen and is showing continuing vigor almost three years after the currency began a sustained rise. But the Economic Planning Agency, in its 1988 economic white paper released in early August, points out that a year ago few expected such a favorable result. At that time, growth was slow, and EPA was expecting only a modest improvement. Many private economists thought EPA too optimistic.

The rest, of course, is history. For the fiscal year that ended March 31, the economy grew a real 4.9 percent. While exports were sluggish, domestic demand was buoyant, helped along by sizable increases in government spending and cuts in taxes. Falling net exports reduced the overall growth rate by 1 percentage point, but private domestic demand pushed it up by 5.5 points and government spending added another 0.5 point.

(distribution) contracts. Both changes could lead to higher imports and lower consumer prices.

OECD has many allies in its emphasis on microeconomic issues. Tax reform, of course, is one of Prime Minister Noboru Takeshita's highest legislative priorities. Washington has given notice that the next round of bilateral talks with Japan will put a heavy emphasis on Japan's competition policy and distribution system. Keidanren, the powerful Japanese business group, has pushed for a fundamental overhaul of Japan's regulatory structure. In an effort to head off repeal of the Large Retail Store Law, the Ministry of International Trade and Industry, however, is reportedly planning to substantially revamp or eliminate the administrative guidance actions that it takes under the statute -- starting with a requirement that large stores consult with the local community before starting construction.

For the Japanese individual, these developments suggest that international pressures are reaching further and further into the fabric of Japanese life. If the proposals are implemented, the changes could be dramatic. Prices on hundreds of everyday items could drop and variety expand. Modifications in the distribution system could affect hundreds of neighborhoods where small shops have flourished under the protective umbrella of government regulation. Washington, OECD and large Japanese business groups seem to be saying that these changes are long overdue.

Douglas Ostrom

Foreign Direct Investment In Japan Stays Strong

Underscoring the importance of a presence in Japan, foreign multinational firms boosted direct investment there in fiscal 1987 (ended March 31, 1988) despite the yen's appreciation against most major currencies. According to the Ministry of Finance, a record \$2,214 million poured into the country compared with \$940 million the previous fiscal year. This 135.5 percent increase far outweighed the 16.5 percent rise in the value of the yen compared to the dollar over the same period. The number of investments also jumped, increasing 28.2 percent from 3,079 in FY 1986 to 3,946 in the April 1987-March 1988 period.

By country (see Table 1), the United States remained far ahead of any other investor in Japan, with a 42.4 percent share in FY 1987. Although the U.S. share declined in FY 1987, the amount of investment nearly doubled from \$488 million to \$938 million; the number of investments also made a big jump. The other country showing a large increase was Switzerland, up 89.9 percent in value. (Investment from the Netherlands more than tripled in value, but this was mainly due to foreigners channeling funds through the Netherlands Antilles tax haven, not domestically generated money.) Reinvestment by Japanese subsidiaries of foreign firms made significant headway, with the number of investments rising 21.6 percent and the value increasing 165.9 percent. Finally, investors from smaller countries (probably Asian) were extremely active; their investments jumped 34.2 percent, and the total value went up 660.8 percent.

By industry (see Table 2), it is clear that foreign investors favored manufacturing activities; its share of total investment rose from 52.7 percent

Table 1: Foreign Direct Investment in Japan by Country, FY 1986-FY 1987

(in millions of dollars)

	FY 1986			FY 1987			Cumulative March 31, 1988		
	Cases	Value	Share	Cases	Value	Share	Cases	Value	Share
United States	489	\$488	51.9%	684	\$938	42.4%	6,245	\$4,010	47.4%
Canada	88	2	0.3	118	4	0.2	490	127	1.5
United Kingdom	310	35	3.7	368	49	2.2	2,281	402	4.8
West Germany	179	47	5.0	237	53	2.4	1,422	347	4.1
France	173	17	1.8	180	20	0.9	1,376	164	1.9
Switzerland	220	89	9.5	311	169	7.6	1,555	565	6.7
Netherlands	179	19	2.0	269	78	3.5	1,031	259	3.1
Other Europe	170	28	3.0	199	79	3.6	1,404	285	3.4
Hong Kong	341	57	6.1	370	36	1.6	3,170	317	3.7
Japan*	305	85	9.0	371	226	10.2	2,647	1,347	15.9
Other	625	74	7.9	839	563	25.4	5,503	638	7.5
Total	3,079	940	100.0	3,946	2,214	100.0	27,124	8,460	100.0

*Investments by Japanese firms with significant foreign participation.

Source: Ministry of Finance

Table 2: Foreign Direct Investment in Japan by Industry, FY 1986-FY 1987

(in millions of dollars)

	FY 1986			FY 1987			Cumulative March 31, 1988		
	Cases	Value	Share	Cases	Value	Share	Cases	Value	Share
Manufacturing	1,563	\$495	52.7%	1,505	\$1,430	64.6%	12,907	\$5,804	68.6%
Food	159	4	0.5	140	7	0.3	878	169	2.0
Textiles	31	19	2.5	3	0	0	142	50	0.6
Rubber and Leather	3	9	1.0	1	1	0	83	38	0.4
Chemicals	139	169	18.0	162	244	11.0	1,827	1,916	22.6
Petroleum	38	16	2.1	34	34	1.5	403	650	7.7
Nonmetallic									
Mineral Products	51	7	0.9	71	3	0.1	358	124	1.5
Metals	88	5	0.7	86	14	0.6	669	427	5.0
Machinery	834	232	24.7	803	1,110	50.1	7,156	2,176	25.7
Other	120	34	3.6	205	17	0.8	1,391	254	3.0
Nonmanufacturing	1,516	443	47.1	2,441	782	35.3	14,217	2,654	31.4
Construction	90	26	2.8	194	2	0.1	792	75	0.9
Real Estate	24	50	5.3	93	20	0.9			
Commerce	590	130	13.8	1,129	291	13.1	7,912	1,138	13.5
Services	467	47	5.0	652	181	8.2	3,567	392	4.6
Transportation	31	12	1.3	35	36	1.6	277	112	1.3
Communications	13	35	3.7	34	26	1.2			
Banking and Insurance	92	87	9.3	82	155	7.0	1,669	937	11.1
Other	209	56	6.0	222	71	3.2			
Total	3,079	940	100.0	3,946	2,214	100.0	27,124	8,460	100.0

Note: Totals may not add up due to rounding.

Source: Ministry of Finance

in fiscal 1986 to 64.6 percent in FY 1987. The machinery sector, in particular, received a much larger injection of cash from overseas, with just over half of all foreign direct investment directed toward it. The nonmanufacturing sector also attracted significantly more foreign money than in the previous fiscal year, but its rate of increase in value was less than manufacturing's (76.5 percent versus 188.9 percent). The sharp increase in the number of non-manufacturing investments may hold the promise of stronger future growth since foreign firms may be testing the waters before deciding to commit significant resources. Foreign investors tried to take advantage of the upward spiral of land prices by quadrupling their stake in real estate. The construction and commerce fields also were active, each showing approximately double the number of investments.

The rising share of foreign purchases of warrant and convertible bonds is an important development in the overall pattern of foreign direct investment in Japan. The value of such "cash loan" investments skyrocketed in FY 1987, accounting for more than a third of the total value (see Table 3). In view of the rising popularity of these instruments among Japanese issuers and since these bonds may be exchanged for stock, MOF has separately listed cash loan flows since FY 1985. Cash loans are not included in the cumulative totals, however, since they remain bonds until converted into stock.

Table 3: Trends in Foreign Direct Investment in Japan, FY 1951-FY 1987

(number of cases and millions of dollars)

Fiscal Year	Stock Acquisition		Cash Loans		Total	
	Cases	Amount	Cases	Amount	Cases	Amount
1951-1980	8,826	\$2,979	n.a.	n.a.	8,826	\$2,979
1981	919	432	n.a.	n.a.	919	432
1982	1,052	749	n.a.	n.a.	1,052	749
1983	2,363	813	n.a.	n.a.	2,363	813
1984	3,685	493	n.a.	n.a.	3,685	493
1985	3,322	780	48	\$150	3,370	930
1986	3,045	760	34	180	3,079	940
1987	3,912	1,453	34	761	3,946	2,214

Source: Ministry of Finance

More interesting, however, are the originators of these cash loans and their recipients. Of the \$938 million that Americans invested in Japan, \$335 million was in the form of cash loans. Only Switzerland (\$71 million of \$169 million) and the residual "Other" category (\$353 million of \$563 million) put similarly large shares into convertible and warrant bonds. By comparison, Japanese subsidiaries and British investors put no money into this form of investment, and most others put very little. West German investors, for example, put just \$3 million of \$53 million into cash loans. Of the \$1,430 million channeled into the manufacturing sector, \$603 million (42.2 percent) was in the form of cash loans. Just over half of all machinery sector investments consisted of this type (\$560 million of \$1,110 million). In contrast only \$156 million (19.9 percent) of the \$782 million directed at nonmanufacturing investments took the form of cash loans.

The overall growth of foreign direct investment in the face of the appreciating yen shows that foreign executives consider a Japan presence a necessary part of their global strategy. Perhaps more important, businessmen in small countries are also taking a more active interest in the Japanese market as shown by the sharp increase in investments from other countries. Many of these investments are probably made by South Korean, Taiwanese, Hong Kong and Singaporean businesses hoping to take advantage of the rising yen and strong domestic growth to increase exports to Japan. The restructuring of the Japanese economy may thus be encouraging foreign direct investment that will, in turn, aid the restructuring process.

Jon Choy

Senate To Consider South African Sanctions

The Senate Foreign Relations Committee will begin consideration of a South African sanctions bill (HR 1580) when the Senate returns from recess in early September. The legislation passed the House August 11 by a 244-132 margin. The bill would ban most trade between the United States and South Africa and would require U.S. investors to sell their holdings in South African companies. The new sanctions are an extension of those that Congress passed over a presidential veto in 1986.

The sanctions, though still popular with the public, do not have the same degree of support in Congress that they enjoyed in 1986, especially among Republicans. Congressional opponents to the new sanctions are not convinced that the ones already in place are effective. Some opponents believe that it is untimely to pass a new sanctions bill just prior to the inauguration of a new administration, which might be able to work out a more viable solution. Others feel that anti-apartheid policy is best served by supporting South Africa's black entrepreneurs via continued trade. In addition, it is not clear whether the sanctions legislation is compatible with the General Agreement on Tariffs and Trade.

An amendment was defeated in the House Ways and Means Committee that would have deleted a provision requiring the president to apply sanctions against foreign countries or companies that take "significant commercial advantage" of the United States' isolation of South Africa. If this provision remains in the legislation, it could have important ramifications for countries, such as Japan, that have strong trade ties with South Africa.

Since Japan took over from the United States as South Africa's leading trade partner in 1987, concerns about Japan-South African trade have been expressed. The Ministry of Finance attributed much of the 1987 increase to the appreciation of the yen; two-way trade was up 15 percent in dollar terms but only 2 percent in yen terms, according to MOF figures. The ministry recently announced that two-way trade figures for the three-month period, May-July 1988, showed that overall trade is declining. The Japanese government also has been encouraging Japanese businesses to lessen trade ties in order to quell international criticism.

The Japan Automobile Manufacturers Association, however, announced that car, truck and bus exports to South Africa were up 30.7 percent for the first

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JAPAN'S SOGO SHOSHA: BACK TO THE FUTURE?

Summary

While the strong yen and the restructuring of the domestic economy have affected all Japanese firms, Japan's general trading companies, sogo shosha, are particularly vulnerable. The sogo shosha were beginning to adjust their structure to the needs of post-industrial Japan when the Japan Economic Institute last examined their activities (see JEI Report No. 34A, August 31, 1984). The sudden and sharp appreciation of the yen, however, destroyed the assumptions that underlaid these first adjustment measures. Having learned some painful lessons, the trading companies have regrouped and now are striking out in new directions within traditional areas of activity.

Overview

There are over 1,700 trading companies in Japan, but only about 17 are considered sogo shosha. They merit the "general" aspect in several ways. The range of products handled by a sogo shosha is very broad, running from raw materials to finished products and from agricultural goods to high technology items. Most are involved in supply creation, investing in mining or production facilities overseas to insure and augment supplies. Each sogo shosha maintains a worldwide network of offices for gathering and handling trade, financial, technical and general economic data. This network not only allows sogo shosha to meet existing demand but also helps create trade opportunities. Geographic and product diversity allows innovative, imaginative deals to be arranged -- deals that would otherwise be impossible or unthinkable. The trade-financing abilities of sogo shosha are of far greater depth and breadth than those of smaller trading firms. Large-scale transactions or deals that would not qualify

for normal financing are not uncommon. Finally, their product and supply diversity gives general trading companies a cushion against a downturn in any one product. Their customers are also insulated from the sudden disruption of any one particular supplier since sogo shosha can usually compensate from other sources.

The sogo shosha continue to account for much of Japan's trade activity. The top six traders handled 50.6 percent of all Japanese trade in fiscal 1986 (ended March 31, 1987); the top four had a combined 33 percent of trade in FY 1987. In terms of exports, the six largest firms accounted for 42.9 percent of the total in fiscal 1986; the four biggest had 25.3 percent in fiscal 1987. Their share of imports was even greater: the top six firms bringing in 63.9 percent in FY 1986, and the top four handling 44.3 percent in FY 1987.

Their role in domestic economic activity is also significant. In terms of gross domestic product, the top six sogo shosha accounted for a combined 11.5 percent in FY 1986. The top four raised their share from 7.8 percent of GDP in fiscal 1986 to 8.1 percent the following year. Taking into account domestic and external activities, the combined sales of the five largest general trading firms were equivalent to 22.8 percent of Japan's total output of final goods and services (gross national product) in fiscal year 1987. To put these giants into better perspective, the gross turnover of any one of the major sogo shosha is double the sales of Toyota Motor Corp. (Japan's largest automotive maker) and three times the sales of Matsushita Electric Industrial Co., Ltd. (the country's largest maker of consumer electronics). Together the six largest firms have 277 domestic and 837 overseas offices, employing a global total of more than 61,000 people. This tally ignores the employment and output of each general trader's one to two dozen subsidiaries and affiliated companies. Sogo shosha are clearly mammoth organizations, behemoths that change direction only slowly.

A False Start

In each of the past three decades, "experts" have predicted the demise of the general traders when economic conditions gyrated wildly. The explosive growth of the 1960s, the oil shocks of the 1970s and the post-industrialization of Japan in the 1980s were all depicted as the beginning of the end for the giant traders. In the early 1980s doomsayers cited the following changes and predictions:

- Slower economic growth combined with conservation and rationalization plans would sharply cut Japan's raw material needs. The sogo shosha were supposed to wither away as demand dropped since these goods still make up a majority of their business.

- The demands of the burgeoning high technology sectors were beyond what the general traders could provide. As high technology spreads throughout Japan and the rest of the industrialized world, so the thinking went, the traders will be left behind.

- Liberalization of domestic financial markets would eliminate the international edge that the sogo shosha had in trade and overseas finance, analysts worried. Japanese firms would have more options and flexibility to arrange their own financing, opening the way for foreign and domestic competitors.

In response, the general trading companies embarked on a series of maneuvers designed to keep them in step with the times:

- Increasing the amount of intermediate and higher value-added goods in their trade mix enabled the traders to build on their strength in handling commodities. As long as the item was needed in high volume and was available from a number of foreign sources, trading companies felt they could apply old practices to new products.

- Diversifying into new high technology areas was another priority. The companies felt that they could help small- and medium-sized foreign firms with top-quality, unique goods penetrate the Japanese market. Manufacturers of specialized computer systems and biotechnology firms were actively sought. By limiting the number of new high technology products, the traders felt confident that they could supply the after-sales support that is vital to success in the field.

- Expanding services trade and activities was also made a goal. Communications was selected as particularly suitable since the giant firms had a great deal of experience in global information networks. By seeking out foreign partners with well-established technology (mostly American operators of value-added networks), the sogo shosha hoped to capitalize on the deregulation of the domestic telecommunications market.

- Engaging in third-country trade, where both the buyer and the seller are non-Japanese, was the final component of their strategy. Using their experience and global contacts, the sogo shosha expected to become the world's trade middlemen.

The success of these four schemes in the first half of the 1980s varied widely from company to company, with only the last proving mostly successful. (The vote is still out, however, on the telecommunications ventures.) In general, critics were correct in arguing that the traders would move too slowly in fast changing markets, would be unable to successfully market the new products, would have trouble supporting state-of-the-art products, and lacked experience in most service areas. Given time, the companies could have overcome these deficiencies. The yen's sharp appreciation against the dollar and Tokyo's pledge to cut reliance on exports and boost domestic demand, however, presented an entirely new set of problems. The traders' attempts to cope with the first problems became moot.

New Rules of the Game

Since most trading company revenue is derived from foreign trade, it is not surprising that the yen's rise against most major currencies shook the general traders to their foundations. With most contracts denominated in dollars, sogo shosha watched helplessly as the yen rose and already thin profit margins

dwindled. Moreover, since trade contracts take several months to complete, the traders found it difficult to project exchange rates, although hedging in the foreign exchange market gave them some protection. Deals, therefore, were difficult to arrange.

More important was the rising yen's impact on the economy as a whole. On the one hand, the combination of the strong yen with low global commodity prices meant that the return on raw materials trading, always limited, was stagnant at best and often smaller. The pause in growth as firms adjusted to the high yen also meant dampened demand for many *sogo shosha* products, especially some of the new high technology equipment. Japanese manufacturing firms began to move operations offshore as production in Japan became too costly relative to nations such as South Korea and China. This posed a long-term threat to the general traders. Less production at home means restricted demand for the industrial inputs that are bread and butter to the *sogo shosha*.

On the other hand, the strong yen and the government's domestic demand stimulation policy opened the door to new growth options. The *sogo shosha* are well positioned to take advantage of the surge in imports generated by both the yen's greater buying power and the new emphasis on consumption. With their experience in exporting plant and equipment, the general traders also can offer advice and support to domestic firms interested in foreign direct investment. Finally, the stronger yen provides Japanese firms with more leverage to finance third-country trade and development.

New Strategies to Match

Chastened by the failure of numerous ventures in high technology products and services, the *sogo shosha* have recast their strategies to meet the new situation. At first glance, it would appear that the same tactics are being employed: modernizing traditional lines by adding high technology products; diversifying into new areas of goods and services; and becoming more involved in third-country transactions. Yet the new approach is more subtle and has new features.

- The general traders are adapting the old practice of supplying raw materials by commissioning the production of intermediate industrial products and consumer goods tailored to the Japanese market. Instead of simply buying what is available, *sogo shosha* are getting overseas manufacturers to produce textiles, apparel, food products, consumer appliances and industrial equipment that better match Japanese needs and tastes. In addition, many products can now be profitably imported thanks to the yen's appreciation.

Examples of this new approach abound, although the most striking is the surge in imports of low-end audio and video products from South Korea and Taiwan. Consumers are becoming more price conscious and open to non-Japanese manufactures, just as Japanese retailers and distributors are searching for products with better profit margins or unusual features.

Investment in foreign producers or production facilities is a variation of this theme as *sogo shosha* attempt to stimulate trade. This works in both directions by funding small- and medium-sized domestic and foreign firms that could not afford to export to or from Japan on their own. This tactic is used

across a wide range of industries from low technology consumer goods, such as food products and light manufactures, to high technology electronic or medical products.

Mitsui & Co., Ltd., for example, put \$2 million into Imatron Inc. of South San Francisco, California to help that firm improve its computerized tomography scanners for the Japanese market. A C. Itoh & Co., Ltd. subsidiary has backed the effort of one American firm to develop structural composites; that company, Windecker Inc. of Reno, Nevada, will eventually market products in Japan. Sumitronics Inc., a Sumitomo Corp. subsidiary, has set up a Tokyo office to help American firms to sell their integrated circuit and software design technology.

- The major traders have established subsidiaries dedicated to handling the special needs of high technology products. C. Itoh Technoscience Co., Ltd. and Marubeni Hytech Co., Ltd. are two examples. These smaller offshoots have both the agility and the expertise to adequately support rapidly shifting markets for advanced products. Coupled with the financial and distribution strength of the parent, the arrangement has proved much more effective.

- Efforts to raise the value of traditional lines are also proceeding in a slightly different fashion. The traders are helping to form joint research ventures between Japanese and foreign firms in exchange for trading rights or licenses. Biotechnology has received a great deal of attention, especially in relation to agricultural and medical products. Numerous projects to develop new seed strains or medical tests through biotechnology have been launched. Since both these products are likely to be traded in volume and to require little after-sales support, they are well suited to sogo shosha. Development is also being pursued of special textiles, such as non-woven types, and of metals, including composite-reinforced varieties.

Realignment of traditional lines in non-traditional ways is another strategy. While the need for oil and other raw materials may be on the decline in Japan, it is on the way up in other areas of the world. By adding to or initiating foreign investments, the sogo shosha can use their vast experience to aid foreigners. The process is particularly striking in the steel industry. In cooperation with Japanese steelmakers or alone, sogo shosha are investing in new American processing and service facilities. And in the crude and refined petroleum trade, Marubeni Corp. has opened a second U.S. operation, Pennsylvania Trading International Inc., to service a growing U.S. energy demand.

- The general traders are both following and helping the movement of production facilities out of Japan, particularly into the United States. In response to the numerous automotive plants opened or planned by Japanese makers, the sogo shosha have set up consulting services to help traditional Japanese suppliers relocate. They also have established their own joint ventures (mostly steel service centers and parts distributors). For example, Nissho Iwai Corp., in cooperation with Eagle Industrial Installations Inc., has set up a consulting service for Japanese firms wanting to build U.S. plants. Nissho Iwai also has set up a company to market flexible manufacturing systems in the United States with Yamazaki Mazak Corp.

The sogo shosha are also helping Japanese firms with an established overseas presence to modernize or expand those facilities. In one case, C. Itoh

aided Shima Seiki Manufacturing Co., Ltd. to add the production of computer graphics terminals to activities at its Cranberry, New Jersey plant, which previously turned out only knitting machines.

- Services trade development has also been fine-tuned, although the prospects for many are still unclear.

- Venture capital is receiving renewed attention, not only for its high returns but also as a window on new technologies. Sumitomo, for example, has invested \$2 million in W.R. Grace & Co.'s Grace Venture Partnership II and \$1.7 million in Hambro America Inc.'s Hambro International Venture Fund II.

- Food franchises and restaurants are also current favorites of sogo shosha, targeted both at the Japanese and American markets. Examples include: Mitsui, which has plans for a Japanese chain of fast-food chicken outlets (El Pollo Loco) with Denny's Inc.; Sumitomo, which will bid with Marriott Corp. to provide on-ground and air meal service at the Kansai International Airport now under construction; and Sumitomo, which will help Sushi-Iwa Co., Ltd. to open 50 sushi restaurants in the United States.

- Leisure services is another area of sogo shosha activity. In an attempt to capitalize on the health/exercise boom that is gripping both Japan and the United States, the general traders are opening athletic and sports clubs in both countries. Resort development and increased imports of sporting goods are other aspects of this thrust.

- Industrial services are also being promoted, including uniform rental, cleaning and waste management. Although hardly glamorous, this field is highly promising both in Japan and the United States. Training in high technology fields offers another promising area. Boeing Computer Services Co. and Nissho Iwai have an agreement to train Japanese in artificial intelligence engineering. Training will first take place at Boeing's Seattle facilities, but a center in Japan is also planned. Additionally, some of the sogo shosha are venturing into computing services: a C. Itoh subsidiary has added a Cray Research Inc. X-MP to offer supercomputing services to Japanese clients that cannot afford to buy such machines.

- A major commitment to communications is still a part of the strategy. Sogo shosha have shares in several of the new Japanese common carriers and in the consortia servicing Japan's international communications needs. All these ventures face two major problems: too many new entrants may make it impossible for any one of them to win enough customers to be viable, and powerful, entrenched competition -- Nippon Telegraph and Telephone Corp. in the domestic market and Kokusai Denshin Denwa Co., Ltd. for international services -- may prove difficult to overcome. In response, however, general traders are broadening their assault. For the value-added network market, Mitsubishi Corp., in cooperation with IBM Japan Ltd., is developing an on-line transaction processing system that is intended for banks. Mitsubishi's Net One Systems Co., Ltd. subsidiary is also selling U.S. local-area network technology. In the entertainment area, Sumitomo has formed a partnership with Viacom International Inc. to buy and run cable television stations. Mitsubishi and the Seibu Saison Group are bringing the Entertainment Sports Programming Network (ESPN) to Japan, both on the air and by videocassette.

- Sogo shosha also are playing a major role in overseas real estate activity, thanks to the yen's expanded buying power. Although most traders have been active in the field for many years, the pace and the size of their deals have increased dramatically since 1986. After two trial projects, C. Itoh will build several hotels a year in cooperation with Holiday Corp. (Holiday Inns). Mitsui is backing a project with Dorick Development Inc. to construct 164 homes in the San Francisco area. Mitsui is also offering shares in U.S. real estate syndicates through a subsidiary. In addition to providing the usual consulting services (such as Mitsubishi's MIC Consulting Inc., which is centered on the New York city market), the traders are coming up with new ideas. Marubeni has a subsidiary, Estmak Inc., that helps clients find and remodel old New York buildings, such as schools and factories.

- Penetration of the nascent high technology market offers the most interesting twist to the sogo shosha restructuring. One aspect is the funding of leading-edge research and development. Marubeni, for example, has invested \$5 million in RPC Industries Inc. along with Fuji Electric Co., Ltd. In a reversal of roles, Fuji is interested in marketing RPC's existing electron beam and ultraviolet industrial curing systems, while Marubeni is interested in developing the technology for use in the food industry. Mitsubishi has brought together NTT and the Battelle Memorial Institute for a project on optical ICs. It is not at all clear if NTT's technology can be brought closer to commercialization in Battelle's Columbus, Ohio laboratories, but it is certainly a noteworthy effort.

To overcome the criticism that they lack high technology experience, sogo shosha are focusing on markets where everyone is starting from scratch. The commercialization of outerspace is a prime target. Nissho Iwai is particularly interested in this area and is establishing relations with the National Aeronautics and Space Administration, Japan's National Space Development Agency and private companies in the field. More immediately, Sumitomo is trying to market United Technologies Corp.'s environmental and life-support systems to NASDA. The general traders are trying to generate excitement about NASA's space station plans, but they realize that the risks are quite high.

Although not truly a nascent industry in Japan, defense and aircraft technology are drawing more interest from the general trading firms. Mitsui and C. Itoh have partnered with Fuji Heavy Industries Co., Ltd. and Kawasaki Heavy Industries Co., Ltd. to produce the V-22 Osprey tilt-rotor aircraft. The craft, combining features of helicopters and conventional airplanes, was developed by Boeing Co. and Bell Helicopter Textron Inc. Mitsubishi is marketing a radar cross-section measuring system developed by System Planning Corp. of the United States.

- Third-country trade will also continue to grow as a share of general trading activities. The logic behind this is simple: although Japan's need for commodities traders may stagnate or decline, demand from other countries will always be present. Why not offer their vast experience and resources to these new clients? Combined with the power to finance deals, the proposition is quite attractive. Sogo shosha hope to play a major role in the development of the Chinese and the Soviet economies as they restructure. They also hope to serve as middlemen as developing countries reach out to new trading partners. The potential for trade between South Korea and Taiwan on the one hand and the Soviet Union and China on the other is certainly there, but the first two barely talk

to the latter pair, much less trade. By acting as an insulator, general trading companies may be able to open entirely new markets.

Back to the Future

In retrospect, it is clear that the sogo shosha strategy for dealing with the strong yen and economic restructuring rests primarily on new slants to traditional activities: trade in low-end consumer goods that can be treated like bulk commodities; creation of sources for these mass goods; investment in new, higher value-added products that complement and extend existing offerings; and use of their experience and resources, which had been gained trading for Japan, to help other countries develop their trade and economies. The only new feature appears to be forays into novel, developing fields.

The success of this "back to the future" strategy rests with the stability of exchange rates and the progress of economic restructuring. If the strong yen is really here to stay, and if the government continues to deregulate and reform institutions, the sogo shosha will have breathing room to learn the ropes. Other factors could also lengthen the adjustment period. The truce between Iran and Iraq has set off speculation about the money to be made rebuilding their war-torn economies. This could spur exports of plant and equipment that have been steadily sinking in the face of competition from South Korea and the stronger yen. Many general traders are expanding their Middle East staff in expectation of orders. The question is whether suitable payment can be arranged -- payment-in-kind with crude oil is not particularly attractive at the moment. Economic reform in the communist world also could revive demand for sogo shosha services, but the political risks are not inconsequential.

When questioned about these new activities, the unanimous opinion of the general traders is that it is too early to tell. They agree that things are not going as well as hoped but add that they are in for the duration. Even if the strategy pans out poorly, the sogo shosha realize that they must continue to try new ideas and approaches. To stand still is to commit suicide.

For further information, contact Jon Choy.

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The views expressed in this report are those of the author and do not necessarily represent those of the Japan Economic Institute.

JEI Report will not be published September 9, 1988 because of the Labor Day holiday. The next issue will be dated September 16, 1988.

Appendix A: Trade by Type

(In percent of each company's total trade)

<u>Fiscal Year</u>	<u>Domestic</u>	<u>Exports</u>	<u>Imports</u>	<u>Third Country</u>
a. C. Itoh & Co., Ltd.				
1983	45.8%	16.3%	18.8%	19.1%
1984	44.0	18.1	18.3	19.6
1985	44.5	18.6	16.6	20.3
1986	55.3	17.9	9.9	16.9
1987	55.6	14.3	10.8	19.3
b. Mitsubishi Corp.				
1981	38.1	18.4	32.0	11.5
1982	37.0	18.5	33.6	10.9
1983	36.0	17.0	33.1	13.9
1984	35.6	16.5	32.0	15.9
1985	38.7	15.5	27.9	17.9
1986	46.3	17.6	19.7	16.4
1987	45.3	17.0	19.5	18.2
c. Sumitomo Corp.				
1980	32.0	21.4	16.6	10.0
1981	50.0	26.3	15.3	8.4
1982	49.8	25.8	15.8	8.6
1983	49.3	23.7	16.4	10.6
1984	48.9	21.2	17.2	12.7
1985	46.5	21.5	20.8	11.2
1986	48.1	23.7	18.1	10.1
1987	50.4	21.0	18.1	10.7
d. Mitsu & Co., Ltd.				
1980	39.0	18.0	22.0	21.0
1981	38.0	21.0	21.0	20.0
1982	36.0	20.0	24.0	20.0
1983	39.0	17.0	25.0	23.0
1984	33.0	17.0	24.0	26.0
1985	34.0	17.0	22.0	27.0
1986	40.0	21.0	16.0	23.0
e. Marubeni Corp.				
1981	36.0	26.4	19.0	18.6
1982	35.4	28.8	19.9	16.0
1983	34.5	28.3	19.7	17.5
1984	33.3	26.1	21.2	19.4
1985	33.6	24.9	20.2	21.3
1986	39.0	22.4	15.0	23.6
f. Nissho Iwai Corp.				
1981	37.4	18.1	27.4	17.1
1982	33.7	17.8	26.0	22.5
1983	34.6	16.0	27.2	22.2
1984	32.5	15.5	28.1	23.9
1985	31.3	14.5	28.4	25.8
1986	35.1	12.7	30.4	21.8
1987	33.0	9.2	30.3	27.6

Source: Company annual reports.

Appendix B: Trade by Commodity Group
(in percent of each company's total trade)

a. C. Itoh & Co., Ltd.

<u>Fiscal Year</u>	<u>Machinery</u>	<u>Metals</u>	<u>Chemicals and Energy</u>	<u>Textiles</u>	<u>Food Products</u>	<u>Other</u>
1983	21.9%	14.6%	32.8%	12.7%	13.3%	4.8%
1984	24.8	14.5	32.0	12.4	12.0	4.6
1985	28.1	14.0	30.1	11.6	11.5	4.8
1986	32.8	18.2	19.5	12.3	11.8	5.4

b. Mitsubishi Corp.

<u>Fiscal Year</u>	<u>Machinery</u>	<u>Metals</u>	<u>Chemicals</u>	<u>Energy</u>	<u>Food Products</u>	<u>Other</u>
1981	19.8	22.6	8.1	26.8	14.2	8.5
1982	21.3	22.2	8.0	26.9	13.7	7.9
1983	19.1	21.6	8.1	28.7	15.0	7.5
1984	19.0	21.1	8.1	30.8	13.8	7.2
1985	21.1	21.4	8.0	29.9	12.5	7.2
1986	29.0	22.9	8.8	16.1	14.2	9.0

c. Sumitomo Corp.

<u>Fiscal Year</u>	<u>Machinery</u>	<u>Metals</u>	<u>Chemicals and Energy</u>	<u>Textiles</u>	<u>Food Products</u>	<u>Other</u>
1980	24.3	29.6	28.0	2.4	6.7	9.0
1981	26.8	30.4	25.8	2.2	6.6	8.2
1983	28.1	29.6	24.7	2.3	6.9	8.4
1984	28.7	29.7	24.5	2.2	6.6	8.3
1985	29.5	30.5	24.4	2.5	6.3	8.1
1986	33.4	32.8	16.5	2.6	6.3	8.4

d. Mitsui & Co., Ltd.

<u>Fiscal Year</u>	<u>Machinery</u>	<u>Metals</u>	<u>Chemicals and Energy</u>	<u>Textiles</u>	<u>Food Products</u>	<u>Other</u>
1980	15.0	27.0	27.0	4.0	19.0	8.0
1981	18.0	26.0	28.0	4.0	16.0	8.0
1982	18.0	21.0	30.0	4.0	17.0	7.0
1983	16.0	23.0	33.0	4.0	18.0	6.0
1984	16.0	24.0	37.0	3.0	15.0	6.0
1985	18.0	25.0	35.0	4.0	12.0	6.0
1986	21.0	30.0	24.0	4.0	14.0	7.0

e. Marubeni Corp.

<u>Fiscal Year</u>	<u>Machinery</u>	<u>Metals</u>	<u>Chemicals and Energy</u>	<u>Textiles</u>	<u>Food Products</u>	<u>Other</u>
1981	25.3	20.4	24.7	8.8	14.6	6.2
1982	29.1	19.0	23.6	9.2	12.9	6.2
1983	27.5	19.2	25.8	9.2	11.7	6.7
1984	29.2	17.5	26.3	8.8	11.7	6.6
1985	28.7	18.2	27.3	9.1	10.5	6.1
1986	28.0	19.7	25.0	10.6	10.6	6.8

f. Nissho Iwai Corp.

<u>Fiscal Year</u>	<u>Machinery</u>	<u>Metals</u>	<u>Chemicals and Energy</u>	<u>Textiles</u>	<u>Food Products</u>	<u>Other</u>
1981	19.4	31.6	27.1	5.6	7.9	8.4
1982	21.3	28.8	28.8	5.3	7.4	8.4
1983	19.6	28.9	24.5	5.2	7.3	14.5
1984	19.1	29.3	26.2	5.0	7.3	13.1
1985	18.0	29.5	28.5	4.6	7.2	12.2
1986	16.5	37.8	21.2	5.2	7.2	12.1

Source: Company annual reports.

NOTE

ONLY THE FOLLOWING PAGES OF THIS
PUBLICATION HAVE BEEN FILMED

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J A P A N · E C O N O M I C · I N S T I T U T E

JEI

R E P O R T

A Two-Part Report: A and B

NO. 348
September 2, 1988

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Investment In Japan Booming

Add a chapter on domestic investment to the story of Japan's surprisingly strong economic growth in the past year. Consumer spending and government expenditures have received well-deserved credit for helping Japan to overcome the weakness in its export markets and the influx in imports that are two consequences of the appreciating currency. But neither of these factors grew as fast in fiscal year 1987, which ended March 31, as private fixed non-residential investment. This category was up 10.1 percent in price-adjusted terms for the year and accounted for 1.9 percentage points of the 4.9 percent rise in real gross national product. Put another way, 19.6 percent of the economy contributed 38.3 percent of the economy's growth in FY 1987.

As a factor in economic expansion, such investment is a gift that keeps on giving. Increased demand for goods and services pushes the economy forward when the investment occurs. Later, when plant and equipment come on line, the ability to produce goods and services increases, providing another benefit.

Few would dispute that the willingness of Japanese firms to put funds into new investment has been an important factor in the country's remarkable postwar record of superior economic performance. Seen in this light, the recent figures -- which by some measures are record highs -- are even more remarkable. While investment as a percentage of real GNP dipped from 18.8 percent in FY 1970 to 14.1 percent in FY 1977, it has been climbing again in the past few years. By January-March 1988 the rate reached 20 percent, surpassing a previous peak of 18.9 percent achieved in the second quarter of 1970.

In recent years firms have been able to buy investment goods relatively inexpensively. This is reflected in Japan's GNP data, which show an almost constant ratio of fixed non-residential private investment to GNP between FY 1980 and FY 1987 if measured in nominal terms but a rising one if measured in real yen (see Table). The falling relative cost of investment goods may have contributed to the relative increase in real investment. The increase in the real figure means that investment has been growing faster than GNP, but the stability of the nominal figure suggests that increased investment has not been coming at the expense of other kinds of spending and investment.

Japanese Private Fixed Non-Residential Investment

<u>Fiscal Year</u>	<u>Nominal Investment/ Nominal GNP</u>	<u>Real Investment/ Real GNP*</u>
1970	20.8%	18.8%
1975	16.0	14.1
1980	19.7	15.8
1981	18.6	15.4
1982	18.0	15.8
1983	14.9	16.0
1984	15.3	16.9
1985	18.3	18.1
1986	19.1	18.7
1987	18.5	19.2

* 1980 prices

Source: Economic Planning Agency

Investment in plant and equipment in FY 1987 got a boost from the economic expansion that began in late 1986. In the initial stages of recovery, firms use their existing capacity more fully. As the expansion continues, they find they have to build new capacity. That is happening now. Low interest rates in FY 1987 also contributed to making investment more attractive.

None of these figures takes into account the well-publicized expansion of Japanese firms abroad. While eventually such expansion may come at the expense of capacity growth in Japan, it has not so far. On the contrary, the data suggest that Japanese firms are strongly committed to production at home.

The Bank of Japan estimates that, for the manufacturing sector, direct investment overseas came to 3.3 percent of domestic fixed investment in FY 1986 and 4.7 percent in the first half of FY 1987.

Investment is likely to be even stronger in FY 1988 than in FY 1987. A widely watched predictor of investment intentions, machinery orders from the private sector (excluding shipbuilding and electric power), has been bullish. For the nine months through June, every month has shown year-to-year increases in double digits, with June coming in with a 23.5 percent increase. Consistent with this, NRI & NCC Co., Ltd. forecasts that real private fixed investment in FY 1988 will increase another 12.1 percent on top of FY 1987's 10.1 percent expansion. If its calculations are correct, the 2.4 percentage point contribution to overall GNP growth will be almost half the total of 4.9 percent real economic growth expected for the year.

In FY 1988 a new positive factor may come into play. During the boom years of the 1960s and the early 1970s, the average age of Japan's corporate facilities dropped rapidly as firms expanded their productive capacity. At the end of 1973 manufacturing facilities were 6.6 years old on average, according to the Economic Planning Agency. This was down from 8.8 years at the end of 1967. With the start of slower economic growth in the late 1970s, however, Japan's plant and equipment began to age, with the average creeping back to 8.8 years by the end of 1987. Eventually, wear and tear and advancing technology dictate replacement. That process may accelerate in FY 1988. The Ministry of International Trade and Industry predicts that "renewal investment" is expected to show a nominal 13.9 percent in FY 1988 after dropping about 8 percent in FY 1987.

However, the high levels of investment in Japan may not have the same effect on future aggregate economic growth as they have had in the past. The Economic Planning Agency believes that the economy will be getting less bang for its buck (or yen). In its calculations using a capital coefficient that relates investment to increased production levels, EPA argues that, yen for yen, investment in the nonmanufacturing sector produces less effect than it does in the manufacturing sector; furthermore, the coefficient is becoming less favorable for nonmanufacturers while remaining stable for manufacturers. Since nonmanufacturing accounts for an ever larger share of the whole economy, the result is to make the economy-wide coefficient less favorable, suggesting investment will do less to increase the capacity of the economy than previously.

But this is a long-term problem, if that. The Bank of Japan is worried that manufacturing investment currently looks too strong. Its February forecast of manufacturing investment predicted a nominal 18.6 percent hike in FY 1988. However, this figure is close to the 20 percent level that the bank has warned could trigger inflationary pressures through the increase in demand for capital goods. The bank also worries that, once new investment is in place, there will be excess capacity. Better to postpone some investment to 1989, the bank says, and avoid these problems.

U.S. firms will be very interested in seeing whether Japan's manufacturing firms will heed the bank's warning, and what will happen if they do not. With Japanese manufacturers doing more than 95 percent of their investing at home, U.S. companies realize that competition from goods produced at least

partly in Japan will remain important, the increase in Japanese direct investment in the United States and elsewhere notwithstanding.

Douglas Ostrom

Prefectural Politics Complicate Tax Debate

Much more will be at stake in the September 4 by-election in Fukushima prefecture than the governorship and an upper house seat. The aftershocks of this election could affect passage of controversial tax reform legislation as well as the ruling Liberal Democratic Party's influence in the Diet, LDP secretary general Shintaro Abe's control of the party and Noboru Takeshita's grip on the prime ministership. All this could happen because two LDP members insisted on squaring off against each other for the governorship.

A local factional feud evidently compelled former construction ministry bureaucrat Toshio Hirose and upper house member and finance vice minister Eisaku Sato to openly defy Tokyo and throw their hats into the ring. At first, the party leadership urged Mr. Sato not to seek the governorship since he would need to resign his upper house Diet seat; that, in turn, would necessitate a by-election to replace him and, it was feared, allow the opposition parties another shot at weakening LDP dominance in the parliament. Ignoring this counsel, Mr. Sato decided to run as an independent. The LDP then threw its support behind Mr. Hirose.

In an apparent attempt to broaden his support, however, Mr. Hirose cut a deal with the Japan Socialist Party to oppose the prime minister's consumption tax proposal in return for JSP backing. He will also run as an independent candidate but with joint support from the local LDP and JSP chapters. Mr. Hirose enjoys such strong support at the grass roots that the local LDP chapter has refused to cancel its endorsement despite Tokyo's objections. The former government bureaucrat told an August 10 press conference that he reached a five-point policy agreement with JSP because he felt obliged to take into account "the opinions of all voters" on the tax issue. (JSP reportedly controls approximately 200,000 votes in Fukushima.)

The Hirose defection prompted the Sato campaign to demand that the LDP leadership withdraw its support for the former government bureaucrat. Prime Minister Takeshita immediately expressed his displeasure with Mr. Hirose's action. Reinforcing the prime minister's disavowal, Mr. Abe stated that "the LDP can never support a candidate who expresses outright opposition to the consumption tax . . . [which is] the biggest political task of the Takeshita cabinet." In the sometimes capricious style of Japanese politics, the ruling party has since switched its support to Mr. Sato.

What has heightened LDP concerns about this prefectural race is a fear that this may become "another Iwate." The JSP won a by-election race in Iwate prefecture in March 1987 -- a victory that political pundits contend led to the defeat of then Prime Minister Yasuhiro Nakasone's sales tax proposal. Thus, the ruling party leadership is concerned that a Hirose victory in Fukushima would lend credence to the anti-tax arguments espoused by the opposition parties and undermine the already shaky base of public support for the consumption

Trade and Payments Data

(in millions of dollars unless otherwise indicated)

	1986	1987	January- June 1987	January- June 1988	April 1988	May 1988	June 1988
<u>Japan's Balance of Payments</u>							
Trade Balance	\$92,827	\$96,386	\$48,411	\$43,492*	\$8,485*	\$6,606*	\$7,380*
Exports (f.o.b.)	205,591	224,605	106,338	122,754*	21,941*	20,061*	21,407*
Imports (f.o.b.)	112,764	128,219	57,927	79,262*	13,456*	13,455*	14,027*
Current Account Balance	85,845	87,015	43,724	37,754*	7,115*	5,792*	6,426*
Long-Term Capital (net)	-131,461	-136,532	-76,574	-51,495*	-10,107*	-16,245*	-10,001*
Overall Balance	-44,767	-29,545	-19,329	-11,009	-3,525	-7,314	-8,864
International Reserves (end of period)	42,239	81,479	69,273	87,700	86,838	87,244	87,700
<u>Japan's Customs Clearance Trade</u>							
Trade Balance	82,743	79,706	40,038	33,650	6,766	5,167	5,919
Exports (f.o.b.)	209,151	229,221	108,395	125,480	22,478	20,650	22,056
Cars	32,945	35,693	17,026	18,787	3,542	3,191	3,073
Steel	12,706	12,610	5,865	7,034	1,177	1,219	1,347
Imports (c.i.f.)	126,408	149,515	68,357	91,830	15,712	15,483	16,137
Crude Oil	19,481	20,663	10,057	10,522	1,706	1,488	1,585
Manufactured Products	52,781	65,961	29,507	44,144	7,843	7,530	7,773
<u>Japan-U.S. Trade</u>							
Trade Balance	31,401	52,090	24,641	20,930	4,131	3,401	3,625
Exports (f.o.b.)	80,456	83,580	39,190	41,468	7,351	6,907	7,350
Imports (c.i.f.)	29,054	31,491	14,549	20,538	3,220	3,506	3,725
<u>Yen-Dollar Exchange Rate</u>							
(average for period)	¥168.52	¥144.64	¥147.92	¥126.81	¥124.93	¥124.77	¥127.14
<u>U.S. Trade</u>							
Trade Balance	-155,137	-170,320	-84,453	-66,385	-9,891	-9,514	-12,624
Exports (f.a.s.)	227,159	254,122	119,672	158,097	26,218	28,143	27,385
Imports (c.i.f.)	382,295	424,442	204,125	224,482	36,109	37,657	40,008
<u>U.S.-Japan Trade</u>							
Trade Balance	-58,575	-59,825	-29,737	-25,974	-4,436	-4,116	-4,399
Exports (f.a.s.)	26,882	28,249	12,574	18,202	3,016	2,932	3,417
Imports (c.i.f.)	85,457	88,074	42,311	44,174	7,452	7,049	7,816

*Preliminary

Japanese Economic Indicators

(percent change from year-earlier period unless otherwise indicated)

	1986	1987	January- June 1987	January- June 1988	April 1988	May 1988	June 1988
<u>Discount Rate (end of period)</u>	3.0%	2.5%	2.5%	2.5%	2.5%	2.5%	2.5%
<u>Outstanding Money Supply</u>	8.7%	10.4%	9.4%	11.7%	11.3%	11.4%	11.1%
<u>Industrial Production</u>	-0.2%	3.4%	0.5%	10.4%	11.0%	10.2%	9.7%
<u>Manufacturing Operating Rate</u>	-4.6%	0.1%	-3.3%	6.4%	4.9%	6.2%	6.4%
<u>Number of Bankruptcies</u>	-7.1%	-27.6%	-23.1%	-20.4%	-13.7%	-20.1%	-19.0%
<u>Residential Construction Starts</u>	10.4%	-22.7%	18.6%	8.8%	2.0%	4.2%	1.9%
<u>Job Openings to Applications (ratio)</u>	0.62	0.70	0.64	0.94	0.94	0.99	1.05
<u>Nominal Wages</u>	2.7%	1.9%	1.9%	3.0%	3.4%	3.6%	4.4%
<u>Labor Productivity</u>	1.9%	5.8%	1.7%*	12.5%*	12.6%	n.a.	n.a.
<u>Wholesale Prices</u>	-9.1%	-3.7%	-6.5%	-0.8%	-0.7%	-0.5%	-0.6%
<u>Consumer Prices</u>	0.6%	0.1%	-0.4%	0.5%	0.3%	0.2%	0.2%
<u>Yen-Based Export Prices</u>	-15.1%	-5.1%	-7.0%	-3.8%	-2.3%	-1.4%	-2.5%
<u>Yen-Based Import Prices</u>	-35.8%	-8.3%	-19.5%	-3.4%	-3.0%	-2.8%	-2.9%

*Through April of each year only.

For Japan's most recent GNP figures, see JEI Report No. 24B, June 24, 1988.

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1988/A

J A P A N · E C O N O M I C · I N S T I T U T E

JEI

R E P O R T

A Two-Part Report: A and B

NO. 35A

September 16, 1988

JAPAN'S ROLE AS AN INTERNATIONAL CREDITOR

Summary

Even as Japan's current account surplus first mushroomed, then resisted the constricting effects of exchange rate changes, Japan's overseas investments grew apace. In fact, mathematically, current account surplus and net capital outflow are opposite sides of the same coin, both depending in part on Japanese saving and spending behavior. Japanese financial firms have taken advantage of their role as transmission belts for Japan's capital outflows to establish themselves in overseas financial markets. Even if Japan's current account surplus declines or disappears, the financial firms are likely to remain in those markets. Japan's overseas presence and Tokyo's new role as a major financial center add new dimensions to international financial markets already rapidly changing as a result of deregulation, liberalized capital flows and new technology.

Overview

When Japanese financiers talk, the world listens. Real estate agents attempting to sell their landmark commercial properties in large urban areas have to consider Japanese firms both as potential buyers and as factors in the broader economic environment. If Japanese companies were to become reluctant about buying U.S. Treasury securities, the fewer number of buyers would pull up yields on financial instruments across the board, including interest rates on home mortgages, at least temporarily. On the other hand, the willingness of Japanese banks, life insurance companies and industrial firms to keep investing in the United States has so far kept interest rates lower than otherwise and certainly encouraged a larger level of investment in the United States than

would otherwise be possible. Ironically, U.S. rivals of Japanese industrial firms are among the beneficiaries, directly or indirectly getting affordable funds for the investments required to mount a counterattack. Still, one year after the worldwide collapse of stock markets underscored the interdependence of financial markets, Japanese investment has created a sense of vulnerability among some Americans and led to calls for another look at Japan's rapidly expanding presence in world financial markets and particularly at its sharply increased direct foreign investments.

Why Japanese Foreign Investment Is So High

Outbound capital flows are inextricably linked to the savings rate, domestic investment and government spending decisions. Other things equal, higher household savings make more funds available to invest domestically, to finance the government deficit, and to invest overseas. The lower the level of domestic investment and the smaller the government budget deficit, the larger the amount available for overseas capital flows, provided other factors remain constant.

Table 1 compares the savings-investment relationship in the United States and Japan. The Japanese household sector, reflecting its high savings rate, has had a large surplus for lending to business, government and foreign borrowers. American households, reflecting a much lower savings rate, have had much less for these purposes. In addition, the budget deficit as a percentage of gross national product has been lower in Japan than in the United States since 1983. The relatively smaller savings shortfall among U.S. non-financial corporations has not been enough to offset the household and government factors; as a consequence the sectoral financial balance of non-residents with the

Table 1: Sectoral Financial Balances in Japan and the United States

(as percent of GNP)

	1980-85	1985	1987
United States			
Public Sector	-3.4%	-3.7%	-4.1%
Non-residents	0.4	1.4	1.3
Non-financial Corporations	-0.7	0.4	-0.3
Households	-1.0	2.8	2.5
Japan			
Public Sector	-6.1	-4.7	-5.4
Non-residents	11.4	-4.1	7.1
Non-financial Corporations	10.8	-1.1	11.3
Households	2.8	14.0	11.3

Notes: For Japan the public sector includes public enterprises.
The 1987 figures are BIS estimates.

Source: Bank for International Settlements, Fifty-Eighth Annual Report.

United States has been positive in recent years (capital inflow) and negative with Japan (capital outflow). Simply put, the high savings rate in Japan has permitted, simultaneously, a public-sector deficit, high investment levels and capital outflows. Loosened restrictions on capital outflows have resulted in an increased percentage of investment funds being channeled overseas.

Japan's position is hardly unique. Bank for International Settlements data calculated on the same basis as those in Table 1 show that West Germany's public-sector deficit, household surplus and surplus with respect to non-residents are all much closer to Japan's than to this country's.

Japan's Changing International Position

Japan is the world's largest creditor -- meaning that its foreign assets exceed its liabilities by the largest margin -- but its role is of very recent vintage. Even after it became a world economic power in the 1970s, its position as an international investor was a modest one at best. In fact, the private sector was a net debtor as recently as 1981. The mirror image of Japan's rise has been the decline of the United States. The world's largest creditor as recently as 1982, by 1987 America was the largest debtor (see Table 2).

Table 2 Net International Investment Positions
of Japan and the United States

(In billions of dollars at yearend)

	<u>United States</u>	<u>Japan</u>
1967	\$37.0	\$13.9
1973	47.9	13.0
1976	52.7	8.9
1978	74.7	7.0
1979	81.6	8.6
1980	72.7	22.0
1981	76.1	36.2
1982	94.3	26.8
1983	208.3	11.5
1984	147.1	10.9
1985	136.9	24.7
1986	89.5	39.3
1987	1.5	74.3
1988	-110.7	129.8
1989	-269.2	180.4
1990	-368.2*	240.7

*Preliminary

NOTE: Official figures overstate the extent of U.S. foreign indebtedness, since U.S. gold stocks are valued at a small fraction of their market price, and U.S. investments abroad are listed at book value rather than higher market value.

Source: Department of Commerce and Bank of Japan

America's role is the more unusual one. Most industrialized nations are net creditors, with developing countries on balance being net debtors. For example, the U.S. Department of Commerce estimated that for 1987 West Germany's net creditor position was \$165 billion and the United Kingdom's was \$160 billion. Canada, however, was an even larger net debtor relative to its GNP than the United States at \$175 billion, according to the Commerce estimates.

Tables 3 and 4 show the breakdown of Japan's net foreign assets. Until 1984 the government accounted for most of its net foreign position. During the 1970s and the 1980s Japan took several measures to liberalize international capital flows, the most important of which was the Foreign Exchange and Foreign Trade Control Law of 1980, which made free international capital flows the rule rather than the exception. The 1984 yen-dollar accord with the United States accelerated the pace of liberalization. For example, recent steps taken under that measure to breathe life into the Euroyen market have had the effect of swelling the issue of Euroyen bonds by Japanese corporations. A Euroyen bond is a yen-denominated bond issued outside the Japanese bond market by a resident or non-resident of Japan. Such bonds issued by residents, which amount to a capital inflow into Japan, are reflected in Table 5 under external bonds. (Table 5, which describes investment flows, is not comparable to Tables 3 and 4, which describe investment stocks and contain valuation adjustments not reflected in Table 5.)

Most Japanese private long-term investment continues to be in securities, despite the publicity concerning direct investment in manufacturing facilities, distribution and real estate. Within securities, bonds are more important than stock, even though at \$16.9 billion the Japanese were the largest net purchasers of foreign equities in 1987, replacing the British who became net sellers. At the end of 1986, the latest year for which comparable data are available, the foreign stock holdings of Japanese investors at \$13 billion were still far behind the British, who had \$123.5 billion, and the Americans, who had \$61 billion.

Not surprisingly, considering its debtor status and volume of trade with Japan, the United States has received a substantial portion of Japan's overseas investment funds, although there have been substantial year-to-year variations (Table 6). The high percentage accounted for by Luxembourg reflects its status as a center for Eurobond activity. The Securities Dealers Association of Japan puts long-term securities investments in the United States in 1986 at approximately 98 percent in bonds of all types and 2 percent in stocks, with a 93-7 percent split last year. The heavy emphasis on U.S. bonds is one reason Japanese intentions in the U.S. Treasury bond market are so closely watched. At a recent Treasury auction, Japanese buyers reportedly accounted for, depending on the maturity, between 20 and 40 percent of the successful bidders (see, for example, JEI Report No. 21B, May 7, 1988). The actual dependence of the U.S. Treasury on Japanese buyers is hard to gauge. Soon after their successful bids, Japanese investors sell a portion on the secondary market. The heavy volume on the secondary market, where Japanese investors are a smaller percentage of the total, and the high degree of substitutability among Treasury notes and bonds and other long-term instruments suggest that these figures overstate the real importance of Japanese investors in the U.S. bond market as a whole.

Table 3: Japan's Net External Assets

(in millions of dollars)

<u>End of Year</u>	<u>Private Sector</u>	<u>Government Sector</u>	<u>Total</u>
1971	\$-7,088	\$16,861	\$9,773
1972	-6,820	20,687	13,867
1973	-3,021	16,037	13,016
1974	-8,318	17,261	8,943
1975	-10,302	17,320	7,018
1976	-11,653	21,227	9,574
1977	-6,182	28,162	21,980
1978	-2,550	38,764	36,214
1979	850	27,927	28,777
1980	-16,659	28,193	11,534
1981	-18,537	29,455	10,918
1982	2,046	22,636	24,682
1983	11,928	25,331	37,259
1984	47,069	27,277	74,346
1985	104,450	25,371	129,821
1986	138,541	41,810	180,351
1987	146,494	94,250	240,744

Source: Bank of Japan, Balance of Payments Monthly, April 1988.Table 4: Japan's External Assets and Liabilities

(in millions of dollars)

	<u>Assets</u>		<u>Liabilities</u>	
	<u>End of 1986</u>	<u>End of 1987</u>	<u>End of 1986</u>	<u>End of 1987</u>
Long-Term	\$476,136	\$646,181	\$192,336	\$236,181
Private Sector	424,704	565,100	152,192	178,810
Direct Investments	58,071	77,022	6,514	9,018
Trade Credits	31,992	37,189	33	35
Loans	69,211	97,469	1,199	1,101
Securities	257,933	339,677	143,611	166,206
Others	7,497	13,743	835	2,450
Government Sector	51,432	81,081	40,144	57,371
Loans	33,558	43,145	66	47
Others	17,874	37,936	40,078	57,324
Short-Term	251,170	425,450	354,619	594,706
Private Sector	207,876	343,261	341,847	583,057
Monetary Movements	194,713	320,171	322,163	530,072
Others	13,163	23,090	19,684	52,985
Government Sector	43,294	82,189	12,772	11,649
Monetary Movements	43,294	82,175	7,103	3,922
Others	0	14	5,669	7,727
Total	727,306	1,071,631	546,955	830,887

Source: Bank of Japan, Balance of Payments Monthly, April 1988.

Table 5: Japan's Net Long-Term Capital Flows

(in millions of dollars)

	1986			1987		
	Outflows	Inflows	Net	Outflows	Inflows	Net
Direct Investments	\$-14,480	\$226	\$-14,254	\$-19,519	\$1,165	\$-18,354
Trade Credits	-1,836	-40	-1,876	-535	-1	-536
Loans	-9,281	-34	-9,315	-16,190	-119	-16,309
Securities	-101,977	545	-101,432	-87,757	-6,081	-93,838
Stocks	-7,048	-15,758	-22,806	-16,874	-42,835	-59,709
Bonds	-93,024	-2,109	-95,133	-72,885	6,675	-66,210
Yen-Denominated						
Bonds Issued in						
Japan	-1,905	n.a.	-1,905	2,002	n.a.	2,002
External Bonds*	n.a.	18,412	18,412	n.a.	30,079	30,079
Other	-4,521	-63	-4,584	-8,829	1,334	-7,495
Total	-132,095	634	-131,461	-132,830	-3,702	-136,532

*Bonds issued outside of Japan by Japanese institutions.

Note: For outflows, a minus (-) sign indicates an increase in Japanese assets abroad. For inflows, a plus (+) sign indicates an increase in Japanese liabilities to foreigners.

Source: Bank of Japan, Balance of Payments Monthly, April 1988.Table 6: Japanese Investment in Long-Term Foreign Securities
by Registered Nationality of Issuer

(percent of total)

	United States	Britain	West Germany	Luxem- bourg	Canada	Other	Total
1981	25.5%	22.6%	9.7%	23.4%	12.4%	6.6%	100.0%
1982	6.8	32.8	-1.5	26.6	1.5	33.5	100.0
1983	38.3	17.0	1.3	24.4	8.0	11.0	100.0
1984	42.4	14.1	-0.1	23.3	7.7	12.8	100.0
1985	56.4	11.2	0.8	21.1	4.1	6.5	100.0
1986	49.1	12.7	3.2	24.1	6.6	4.5	100.0
1987*	42.1	9.8	7.2	28.6	2.8	9.5	100.0

*January-September

Notes: Totals may not add due to rounding.

Figures do not include yen-denominated foreign bonds but do include foreign currency-denominated bonds issued on the Tokyo market.

Source: Ministry of Finance

Table 7 shows investment in foreign securities by investor. For the years shown, financial institutions have increased their share at the expense of others. In part, this reflects reduced restrictions on financial firms in how they can invest their money, but it also reflects decisions by non-financial firms to invest through tokkin (special money trust) and other indirect means.

Table 7: Japanese Investment in Foreign Securities by Type of Investor

	(in billions of dollars)				
	<u>1983</u>	<u>1984</u>	<u>1985</u>	<u>1986</u>	<u>1987*</u>
Commercial Banks	\$1.8 (13.7%)	\$4.5 (16.5%)	\$12.6 (22.6%)	\$23.1 (22.7%)	\$24.8 (29.8%)
Trust Banks	1.5 (11.4%)	4.1 (15.2%)	12.8 (23.0%)	28.9 (28.3%)	17.3 (20.9%)
Insurance Companies	4.8 (36.9%)	6.4 (23.6%)	8.0 (14.4%)	20.7 (20.3%)	16.8 (20.3%)
Investment Trusts	0.3 (2.1%)	2.5 (9.1%)	3.3 (6.0%)	19.1 (18.7%)	10.0 (12.1%)
Others	4.2 (31.7%)	8.9 (32.8%)	16.8 (30.3%)	16.5 (16.2%)	15.0 (18.1%)
Securities Companies (own account)	0.5 (4.2%)	0.7 (2.8%)	2.0 (3.7%)	-6.4 (-6.2%)	-0.9 (-1.1%)
Total	13.1 (100.0%)	27.0 (100.0%)	55.6 (100.0%)	102.0 (100.0%)	83.0 (100.0%)

*January-September

Note: Some short-term securities transactions are included, making data not comparable to the relevant balance of payments statistics.

Source: Bank of Tokyo, based on Ministry of Finance and Japan Securities Dealers Association data.

Life insurance companies are a good example of how the loosening of restrictions has affected overseas financial activity. As the government has raised the percentage of the insurers' total assets that could be invested, foreign investment has soared. The continuation of another restriction has prevented the companies from making payments to policyholders out of capital gains. In response, the companies have concentrated on securities, especially bonds, where the periodic payment of interest accounts for most of the income. Not surprisingly, an estimated 50 percent of Japanese life insurance companies' holdings of foreign securities are in U.S. Treasury bonds.

The same capital gains provision has led to charges that the Insurance companies have been playing havoc with certain American stocks that pay a high dividend, such as utility companies. The insurance firms buy the stock just in time to claim the dividend and then sell it even at the cost of a capital loss. Because more than one Japanese insurance company has been able to claim the dividend on a single share of an American company on the same day, trading in such stocks on the New York Stock Exchange has been remarkably heavy on the days in question, sometimes boosting the shares of otherwise unremarkable companies to the ranks of volume leaders. Japanese life insurance firms also use another device. They have set up subsidiaries, often in Luxembourg, for the express purpose of capturing capital gains income. The subsidiary then pays the parent a dividend.

New Trends in Foreign Investment

The relationship between savings, domestic investment and net foreign investment is a rigid one. But within that framework, the amount of foreign financial activity can vary greatly. The increase in these activities, especially in the context of a still large investment flow, has raised the foreign profile of Japanese financial firms considerably.

- Japanese institutions and others have become more active traders, buying and selling securities more frequently, increasing their impact on world financial markets even in the absence of an increased capital flow from Japan. The Bank of Tokyo notes that what it calls the net ratio of Japanese bond trading in overseas markets (the net value of securities divided by the traded value) has been declining, indicating more short-term trading. The ratio stood at 0.38 in 1983 but dropped to 0.03 in the first nine months of 1987.

- Private investors have at times changed their behavior, forcing the government to take action. In 1987 just this happened. Table 8 gives a sense of the recent role of the central bank. Negative values indicate outbound capital flows. In total, outbound flows of all types equal the current account surplus. In the first and second quarters of 1987, foreign short-term borrowing soared. The resultant decline in net outbound capital flows led the central bank to step in, reflected in the increase in the net official monetary position in foreign reserves. Japanese analysts suggest that the dramatic increase in short-term borrowing abroad reflects a hedge by Japanese firms wanting to invest abroad: they have moved toward having both sides of their balance sheet in the same currency during a period of unstable foreign exchange markets.

Table 9 amplifies on this explanation. While both nominal short- and long-term rates are lower in Japan than in the United States, the gap is much narrower for short-term securities. If dollar depreciation is anticipated, the short-term spread may be virtually meaningless from a Japanese borrower's perspective because it will be easily offset by the ability to pay in deflated dollars. The result would be a short-term capital inflow into Japan. The long-term spread, by contrast, may be enough to entice a flow of funds the other direction, exchange risk notwithstanding. If a single firm borrows short term in the United States and invests long term, it avoids most exchange risk, although, like domestic U.S. investors, the firm has to contend with other risks, such as the chance that short-term U.S. interest rates will rise, leading to losses. In short, Japanese financial service firms have increased their role as international financial intermediaries, evaluating interest rate differentials and exchange rate movements in an attempt to make a profit.

Table 8: Japan's Capital Account Transactions

(in billions of dollars)

	<u>1985</u>	<u>1986</u>	<u>Year</u>	<u>1987</u>			
				<u>I</u>	<u>II</u>	<u>III</u>	<u>IV</u>
<u>Net Capital Flows</u>							
Long-term Capital	\$-64.5	\$-131.5	\$-136.5	\$-32.2	\$-44.3	\$-22.0	\$-38.0
Short-term Capital*	13.9	59.4	91.8	28.3	34.4	4.2	24.9
of which: Banks	10.8	58.5	71.8	21.9	27.2	-4.8	27.5
Nonbanks	-0.9	-1.6	23.9	1.4	6.5	9.8	6.2
Changes in Net Official Monetary Position	1.4	-13.7	-42.3	-17.0	-12.8	-3.4	-9.1
<u>Equals: Current Account</u> (with sign reversed)	49.2	85.8	87.0	21.0	22.8	21.2	22.1

*Including errors and omissions

Notes: Figures may not add due to rounding.

A minus (-) number indicates a capital outflow or an improvement in net official monetary position.

Source: Bank for International Settlements, Fifty-Eighth Annual Report, and Bank of Japan.Table 9: Premium on Dollar Instruments*

	<u>Short-Term</u>	<u>Long-Term</u>
1985	1.00%	4.28%
1986	1.01	2.74
1987	1.90	4.17
1987: I	1.47	3.21
II	1.86	4.77
III	2.30	4.05
IV	1.98	4.65
1988: I	1.88	4.37

*Interest rates in the United States less corresponding rates in Japan. The rates used for the United States are 10-year Treasury bonds and three-month Treasury bills; for Japan, long-term government bonds and three-month gensakis.

Source: Bank for International Settlements, Fifty-Eighth Annual Report.

The importance of Japanese banks as intermediaries is suggested by data from the Bank for International Settlements. Unlike the balance of payments data, which identify international transactions based on originating and receiving country, the BIS data identify transactions based on the home country of the originating and the receiving firm. Thus, purchases by the European subsidiaries of Japanese banks of securities issued by Japanese corporations in the Euromarket is a capital inflow into Japan according to the balance of payment statistics, but an increase in cross-border asset holdings of Japanese banks by the BIS criteria. By this measure, Japanese banks held 35 percent of all such assets in December 1987, far ahead of the 14.8 percent claimed by the runner-up, U.S. banks. The dominance of Japanese banks by this measure is consistent with their position as the world's largest in terms of assets.

- Activity in the United States real estate market illustrates yet another phenomenon: borrowing by foreign subsidiaries to finance purchases in the country that is host to the subsidiary, a transaction that might not get into international financial flows at all. The result can be considerable confusion. Commerce Department data based on the balance of payments framework put the increase in net U.S. real estate holdings by Japanese at a mere \$1.5 billion in 1987. Private surveys appear to suggest that the amount is far more than that. A study by Salomon Brothers, Inc. puts the figure at \$6.8 billion in 1987, up from \$4.8 billion in 1986. In some contrast, Mitsubishi Bank, Ltd. estimates that worldwide Japanese real estate investment was \$7.7 billion in Fiscal Year 1987 that ended March 31. The discrepancies could arise from U.S. subsidiaries of Japanese firms borrowing in dollars to finance their purchases, transactions that might not enter the balance of payments figures at all. In this sense, U.S. subsidiaries of Japanese firms are treated for data purposes exactly like purely domestic firms.

Several other developments suggest that Japanese firms are becoming increasingly integrated into the American financial services industry. As banks and securities houses become primary dealers of Treasury securities, they move into the inner sanctum of American financial life.

Banking is an activity where Japanese strategy apparently has less and less to do with facilitating capital flows. With their large presence in retail banking in California, Japanese banks want to be perceived as full participants in the American banking industry, not mere investment or trade appendages of their Tokyo parents (see JEI Report No. 3A, January 22, 1988). Insurance companies, noticeably slower off the mark than the banks, are also starting to show more interest in the American market for its own sake, rather than just as a location for investment in Treasury securities and in real estate. (See JEI Report No. 31A, August 12, 1988).

Finally, Japanese securities firms -- among the world's largest -- are here in full force. In addition to conventional securities trading, they are now venturing farther afield, becoming more active in options and futures trading. Yamaichi International (America), Inc., Daiwa Securities Co., Ltd. and Nikko Securities Co., Ltd. have been approved for clearing membership at either the Chicago Board of Trade or the Chicago Mercantile Exchange. In explaining his company's involvement, a Yamaichi executive said that Japan accounts for 25 percent of night trading volume on the CBT. In another area, Yamaichi, like Nomura Securities Co., Ltd., has purchased an interest in an American merger and acquisition specialist firm, possibly signaling more extensive activity in this realm by Japanese companies (see JEI Report No. 30B, August 5, 1988).

The complexity of Japanese international financial activity outside the United States is increasing as well. Faced with restrictions on their activities in Japan, and finding the regulatory environment only slightly better in the United States, Japanese banks are turning to the Euromarket as a hospitable place to do business. Despite Japan's overall creditor status and its particular advantage explained above as a source for long-term funds, Japanese firms have still emerged as the biggest borrowers on international bond markets, located largely in Europe. According to the Bank for International Settlements, in 1987 Japanese firms borrowed \$43.2 billion in the international bond market, surpassing runner-up United States, which borrowed \$24.0 billion. The value of international bonds outstanding saw the United States with \$163 billion compared with \$150.7 billion for Japan.

Outlook

Japan's creditor position creates somewhat conflicting political and economic pressures.

- Decisions to limit overseas investment would affect not just foreign interest rates and equity prices but exchange rates, too. The reason is that, as Japan's foreign investment flows decline, the demand for dollars and other foreign currencies also drop, leading the dollar to fall and the yen to rise.

- As long as Japan has a current account surplus, net foreign assets will rise and investment income will tend to increase, in turn complicating the task of reducing the current account imbalance.

- While these factors might be expected to lead to a stronger yen than otherwise, Japan's foreign assets, to the extent they are denominated in dollars, lose value as the yen appreciates, creating an incentive to stabilize currency values. Furthermore, if investors come to expect instability in the foreign exchange market, they may become reluctant to increase their exposure in overseas currencies.

There is little doubt that being a large net creditor gives Japan more clout in world economic policy. Certainly, in an earlier era, the United Kingdom and the United States found that to be true. One area to watch in this regard is Third World debt. As latecomers, Japanese banks have far less exposure than U.S. banks, although their position is substantial (Table 10). The Federal Reserve Board puts the Third World debt of U.S. banks at \$96 billion in 1988; the latest Ministry of Finance data for Japanese banks (1986) show \$43.5 billion, up from \$38.5 billion in 1985. However, the relatively good health and enormous size of Japanese banks will inevitably make them part of the solution. Building on recent initiatives, Prime Minister Noboru Takeshita proposed a Third World debt initiative at this year's Toronto economic summit of the free world's leading industrial nations that is indicative of a more activist Japanese stance.

As Japan's role in the world economy grows, so too does the use of its currency in international commerce. In 1987, 10.6 percent of Japan's imports were settled in yen, up from 2.4 percent in 1980 and 9.8 percent in 1986. According to the most recent International Monetary Fund data, 6.9 percent of international monetary reserves were in yen as of 1986, up from 1.5 percent in 1980. Some experts, among them Nobuyoshi Araki, economic advisor at the Long-Term Credit Bank of Japan, see the emergence of a yen bloc in East Asia.

Table 10: Third World Loan Exposure of Japan's Nationwide Commercial Banks

(in billions of yen as of March 31, 1988)

	<u>Exposure</u>	<u>As Percent Of:</u>	
		<u>Assets</u>	<u>Equity</u>
Dai-Ichi Kangyo Bank, Ltd.	Y350.0	0.75%	36.6%
Sumitomo Bank, Ltd.	375.1	0.85	39.6
Fuji Bank, Ltd.	313.4	0.72	29.4
Mitsubishi Bank, Ltd.	339.7	0.80	35.0
Sanwa Bank, Ltd.	306.1	0.76	34.6
Tokai Bank, Ltd.	278.6	1.00	48.8
Mitsui Bank, Ltd.	198.4	0.77	37.5
Taiyo Kobe Bank, Ltd.	162.2	0.74	40.2
Daiwa Bank, Ltd.	88.8	0.68	27.1
Kyowa Bank, Ltd.	91.6	0.67	29.5
Saitama Bank, Ltd.	89.9	0.78	34.4
Hokkaido Takushoku Bank, Ltd.	100.0	1.06	52.4
Bank of Tokyo, Ltd.	671.2	3.21	146.5
Total	3,365.0	0.93	42.7

Source: Morgan Stanley & Co.

Of course, some see a threat in Japan's new financial position. While Japanese firms have argued that, as primary dealers, they will help the United States finance its trade and budget deficits, the Congress and the president may see things somewhat differently. As part of the omnibus trade bill passed this year and signed by the president, primary dealer status is to be tied to liberalization measures for domestic Japanese government securities. While many in the Administration and in Congress no doubt see the provision as a lever to open the Japanese market, others may see it as a way to limit, at least slightly, Japanese access to the U.S. market.

Conclusion

Reduced regulation, current account surpluses and large surpluses of savings over investment requirements have contributed to an explosion of international Japanese financial activity. There are signs that Japanese firms, no longer content to be conduits for Japanese funds flowing out of Japan to finance activities abroad, are becoming more active in overseas domestic financial markets and are even exploiting opportunities to raise funds abroad for use in Japan or elsewhere. Whether the Japanese come as borrowers or lenders, their multiplying presence is bringing local investors, stockbrokers and others to an accelerated awareness of Japanese financial power.

For further information, contact Douglas Ostrom.

The views expressed in this report are those of the author and do not necessarily represent those of the Japan Economic Institute.

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American Chip Makers And Users Interface

American makers and users of integrated circuits have achieved a unified position on the controversial U.S.-Japan semiconductor accord. Representatives from the American Electronics Association and the Semiconductor Industry Association tentatively decided September 8 to urge the Commerce Department to replace parts of the July 1986 agreement that have caused friction between the two groups and to pursue fuller Japanese compliance with the pact. The two sides are also exploring whether and how U.S. firms can re-enter the highly competitive market for dynamic random access memory chips, a market dominated by Japanese firms. As for the remaining \$165 million in punitive tariffs imposed on specific Japanese products by Washington in April 1987 in retaliation for Japanese violations of the agreement, prospects for their removal remain slight in this election year.

Although a number of factors are involved, the bilateral pact has become the scapegoat for discontent among American DRAM users faced with increasingly

severe shortages of memory chips over the past year. To implement the pact, the Ministry of International Trade and Industry reduced excess supplies of DRAMs through administrative guidance to dry up sources for lower-price "gray market" vendors around the world. This, combined with the technical difficulties producers encountered in shifting from 256-kilobit to 1-megabit DRAMs and fast-expanding demand for memory chips in Japan, led to short supplies when the U.S. market for computer equipment picked up in the second half of 1987. Computer makers are the most vociferous critics of the semiconductor agreement, claiming that they actually have had to refuse orders because they could not obtain sufficient DRAM chips. Represented by AEA, these firms feel that it is they who are bearing the cost of the pact in the form of higher DRAM prices and reduced international competitiveness. American semiconductor producers, represented by SIA, argue that it is Japan's implementation that is at fault and that the pact is basically sound.

At the start of this year, both sides woke up to the fact that dependence on Japanese companies for DRAMs was a threat to the long-term health of both American chip makers and chip users. The AEA-SIA split also paralyzed U.S. negotiators, who could not discuss changes in the pact without a domestic consensus as to what needed to be changed. AEA and SIA initiated a series of talks aimed at eliminating the negative aspects of the pact and at revitalizing the production of DRAMs in the United States.

The early September AEA-SIA meeting produced a set of broad joint recommendations:

- "To develop and mutually support the adoption of a proposal that would allow the simultaneous suspension and replacement of the Fair Market Value system with a successor cost-based mechanism that is stronger and more effective in preventing dumping and that would include flexible remedies for targeting individual company violators and for taking actions against downstream products where appropriate." Computer makers have argued that Commerce's current system of setting quarterly FMVs is too slow and too broad. According to press reports, one replacement option under consideration is an antidumping duty that would be triggered instantly when cost calculations show unfair prices.

- "To urge that the procedural steps agreed to by SIA and EIAJ (Electronics Industry Association of Japan) be fully implemented, and that specific sectors of the Japanese industry be targeted for increased purchases of U.S. semiconductors and other electronic products."

- "To insist that the Japanese government live up to its commitments under the U.S.-Japan Semiconductor Trade Agreements; and the success of these efforts be measurable in terms of an increased real market share in Japan for U.S.-based companies."

- "To support the sanctions that are in place and to investigate increasing sanctions to insure compliance with the Japanese commitments under the agreements."

SIA's position is that Japan agreed, at least implicitly, to guarantee U.S. producers 20 percent of the Japanese chip market by August 1991. AEA opposes any such guaranteed market share since it would be a de facto cartel

and could lead to higher prices for many components they buy from Japan. The recent proposals give the SIA a major objective: creating a unified U.S. position in favor of greater access to Japan's markets. They also do not go farther than what is already embodied in the bilateral pact, a clear plus for the AEA.

• "To develop extraordinary measures designed to encourage increased U.S. DRAM production with a view to increasing U.S. worldwide market share; and to seek appropriate U.S. government cooperation." After complaining so loudly about the negative impact of Japanese dominance, U.S. chip makers have failed to return to the DRAM market in significant numbers. This situation reveals a long-standing split between chip makers, which need strong prices to fund their enormous capital spending and research and development requirements, and chip users, which want the lowest prices possible. Producers argue that users are only interested in the lowest price and are not willing to support the domestic industry in the cutthroat DRAM market. Chip buyers argue that they should not have to pay the price for the failure of U.S. chipmakers to remain competitive with foreign producers.

What both sides now realize is that the current situation is the worst of both worlds. Market dominance allows Japanese firms to charge high prices for DRAMs, which gives them the cash to produce better computers as well as the next generation of memory chips. AEA and SIA are hoping to commission a study of the best strategy for American re-entry into the DRAM market. Since the recently formed joint American consortium, Sematech Inc., is already exploring production technologies for the 4-megabit DRAM, AEA and SIA may focus on how to foster cooperation between their members to promote the U.S. industry.

Both organizations are now working on detailed proposals to support these points of broad agreement. The two hope to present a full proposal to the U.S. Trade Representative within 60 days. Despite recent Japanese moves to raise DRAM production and also pave the way for greater U.S. sales in Japan, the subject will likely remain a priority on the bilateral trade agenda.

Jon Choy

Japan's Energy Appetite Expands

In a worrisome reversal of post-oil shock trends, the growth of Japanese energy consumption in FY 1987 (ended March 31, 1988) outpaced the growth of real final output. In what some analysts are calling a "reverse oil shock," Japan is reacting to low global energy prices and the restructuring of the domestic economy by increasing its demand for energy. Data from a government agency and a private research organization both show that the shift toward "knowledge-intensive" industry and domestic demand-led growth have raised energy needs, exactly opposite expectations.

According to the Ministry of International Trade and Industry, Japan's consumption of all types of energy rose 5.3 percent in FY 1987, above the 4.9 percent expansion in real gross national product. The increase was the sharpest since FY 1977 and was traced to greater energy use by both industries and households. Consumption of oil and petroleum products rose 4.2 percent, electricity use was up 6.3 percent; 4.1 percent more propane and 5.7 percent more coal were burned. These increases easily outran MITI's projected increases of 2 percent for oil, 1.8 percent for electricity, 2 percent for propane and 1.7

percent for coal. Although a hot summer and a cold winter contributed to the rising demand, MITI pinned the blame on a resurgence by energy-intensive basic industries, including steel, chemicals and paper and pulp. Individuals also played a role, however. Responding to lower prices for gasoline, propane and electricity and reflecting increased purchases of appliances, bigger cars and larger homes, household consumption rose strongly, in some cases by double digits.

Japan's energy elasticity (the rate of energy consumption growth divided by the rate of real GNP growth) rose to 1.08, going above 1 for the first time in four years. (Ratios of less than 1 indicate that the economy is becoming more energy efficient.) Although energy use was kept in check during FY 1985 and FY 1986 by an economic slowdown, officials are alarmed by the sharp change from FY 1986's 0.12 energy elasticity figure.

According to the Japan Research Center for Energy Economics, a private think tank, the picture was slightly better. Overall consumption rose 5.18 percent in FY 1987 (see Table), with industrial use leading the way with a 6.03

Japan's Energy Supply and Consumption, FY 1986-FY 1987

(in billions of kilocalories and percent change)

	<u>FY 1986</u>	<u>FY 1987</u>	<u>Change</u>
<u>Supply</u>			
Petroleum	21,680.1	22,794.0	5.14%
Crude oil	17,334.7	17,343.3	0.05
Petroleum products	4,345.4	5,450.7	25.44
Heating oil	2,905.7	3,995.3	37.50
Coal	7,061.8	7,327.8	3.77
Coking coal	2,088.1	2,237.3	7.15
Steam coal	4,841.1	4,988.7	3.05
Natural gas	4,029.7	4,156.3	3.14
Liquefied	3,827.6	3,936.3	2.84
Hydroelectric power	2,108.9	1,981.1	-6.06
Nuclear power	4,099.2	4,571.9	11.53
Total	38,819.7	40,696.1	4.83
<u>Consumption</u>			
Industry	12,452.6	13,203.3	6.03
Manufacturing	11,334.2	12,029.0	6.13
Pulp and paper	429.2	491.3	14.47
Chemicals	3,092.1	3,269.8	5.75
Nonmetallic mineral manufactures	796.4	912.6	14.59
Steel	3,731.3	3,868.6	3.68
Nonferrous metals and machinery	753.3	813.8	8.03
Households	6,391.2	6,707.3	4.95
Transportation	6,382.1	6,640.7	4.05
Total	25,970.7	27,315.5	5.18

Source: Japan Research Center for Energy Economics

percent increase, followed by a 4.95 percent gain by households and a 4.05 percent increase by the transportation sector. Sharp jumps in consumption by the paper and pulp and the nonmetallic mineral manufactures industries were actually outweighed in terms of energy consumption by modest increases in the much larger steel and chemicals industries. Of the three sectors, only transportation showed an increase that was below the overall rate of economic growth.

The upward trend has continued in the current fiscal year. Petroleum imports, particularly of refined products, are up sharply. Electricity consumption is also up by 6 to 7 percent, easily outstripping the real growth of output. The trend is worrisome to government planners, who nervously eye the rapidity with which Japanese consumers have adopted a more energy-intensive lifestyle. Lower global oil prices allow budget planners to cut government support for energy programs, but they also raise the potential for hardship in the event of another energy crisis. The decline of oil prices and the unexpected consequences of economic restructuring have sent energy planners back to their drawing boards. New long-term energy demand and supply outlooks are in the works.

Jon Choy

New Opportunities For Foreign Nationals In Japan

Imagine the job description. You will be expected to live thousands of miles from home, probably in one of the world's most crowded and expensive cities. You may be required to speak a foreign language, and at first you may have to share a 10-foot-square room with another new employee in a company dormitory. Some of your predecessors in the position became frustrated at the lack of promotion potential. Sound good? Increasing numbers of Americans are said to be seeing the benefits and signing up to work for companies in Japan -- both Japanese and foreign-owned.

Among the advantages are being in one of the world's most dynamic economic environments, sometimes with professional opportunities unavailable elsewhere. Perhaps the American or other foreigner should be grateful even for the opportunity to apply; even now the range of legal jobs open to foreigners in Japan is very restricted, concentrated in those jobs that foreigners are regarded as likely to do better, or at least differently, than a Japanese. On this basis, Seibu Department Stores, Ltd. was recently able to hire "foreign nationals with a sensibility different from that of Japanese." Illegal employment is another matter entirely (see JEI Report No. 15B, April 15, 1988). And, of course, Japanese firms employ thousands in a variety of jobs outside Japan.

Japanese firms have long concentrated their hiring of foreign nationals on foreign language teachers, and language-related employment continues to be important. In 1987, according to a Ministry of Justice report, 53 percent of those hired by Japanese companies were foreign language instructors. Another 9 percent were interpreters, translators or copywriters. But Japanese companies are said to be reaching out, albeit in still limited ways, for other kinds of foreign expertise. Honda Motor Co., Ltd., for example, employed its first six foreign nationals in 1987, eyeing them, it said, for future management positions. Hired straight out of colleges, they were put through the same paces as their Japanese counterparts, including stints on the assembly line and in the sales division.

The Justice Ministry tally leaves out the largest category of all: foreign entertainers and athletes. According to another Justice count of all foreign nationals authorized to work in Japan, this category accounted for about 82 percent of all legal foreign workers and all of the growth in employment of foreign nationals from 1984 to 1986 (see Table).

Foreign Nationals Authorized to Engage in Professional
Activities for Renumeration in Japan

	<u>1984</u>	<u>1985</u>	<u>1986</u>
Trade, business or investment	6,887	6,826	6,773
Teaching at academic and research institutions	336	310	333
Theatrical and other performances and sports events for income	32,952	34,569	44,989
Providers of advanced technology	10	13	18
Skilled labor	511	498	552
Other categories (including teaching) authorized by justice minister	2,110	1,797	2,071
Total	42,806	44,013	54,736

Source: Ministry of Justice

The small numbers of foreign employees are reflected in the totals at individual companies. Kobe Steel, Ltd., which employs about 24,000 people worldwide, is known as one of the pioneers in employing foreign nationals to work in Japan, hiring the first in 1975. Today it still has only 27 on the payroll in Japan. In all, about double that number have worked for Kobe since 1975, suggesting to Kobe much greater turnover than among Japanese workers.

Foreign language ability remains a major factor attracting Japanese firms to foreign nationals, but sometimes technical skills or an understanding of legal practices or foreign markets are the key. U.S. baseball players bring an obvious talent to their game, but American sumo wrestlers have had some success in Japan, too. For some occupations, lower wages are an important consideration. The Ministry of Transportation has proposed that Japanese shipping companies, facing staggering losses in the wake of the yen's appreciation, be allowed to staff their Japanese-registered ships with foreign crews, which would work for far less than Japanese crews. (Ship owners are getting around the current prohibition on foreign workers by registering their vessels abroad.)

Foreign nationals, including an estimated 100,000 illegal alien workers, account for a miniscule fraction of total Japanese employment. Overall, jobholders in Japan numbered 60.8 million in 1987. Legal and illegal hiring of

foreigners in Japan, combined with increased employment in the foreign subsidiaries of Japanese firms, which have hundreds of thousands of workers on their rolls worldwide, is making Japanese firms increasingly multinational in their staffing patterns. With the numbers still small but growing rapidly, the hiring of foreign workers raises questions not only of Japanese corporate strategy but of culture. Japanese employers, for example, believe that Americans bring very different commitments to their jobs and beliefs about the relative importance of work and family, yet increasingly Americans and Japanese are working side by side, sometimes even competing for the same promotions. But Japanese companies are not likely to quickly emulate American practice, where foreign nationals have sometimes risen to the top ranks in multinational companies.

Douglas Ostrom

Aid For Bangladesh

Japan and the United States have initiated massive aid relief efforts in order to help Bangladesh cope with devastating floods that hit in early September. The death toll had risen as of September 22 to 1,000 people, the Japanese Red Cross reported. An estimated 25 to 28 million people are homeless and possibly more are facing starvation, poisonous snakebites, debilitating diarrhea and a host of diseases spread by the polluted water. Already one of the poorest countries in the world, Bangladesh stands to lose one-third of its rice crop and a large portion of its main cash crop, jute. Many farmers who have lost their homes and crops have begun migrating into the cities to find jobs.

Japan, Bangladesh's leading aid donor, has pledged \$135 million for flood relief in addition to the \$290 million in aid that it had already promised for FY 1988. In early September the two governments agreed on a \$28 million grant that will be used to continue construction of transportation links that will connect the capital, Dhaka, and Chittagong, the second-largest city. The money will also be used to repair an irrigation project that was damaged by the floods and to provide a water supply to two towns.

The Japanese Red Cross announced in mid-September that it would send Bangladesh \$128,000 in private emergency aid to supplement the \$80,000 in aid donated earlier this month. The American Red Cross made an initial emergency aid donation of \$50,000 and plans to increase this amount. Overall, \$6.2 million in aid for Bangladesh is being requested from Red Cross/Red Crescent organizations worldwide by the International Red Cross based in Geneva. The aid will be used in a three-part program designed by the International Red Cross working with the Bangladeshi Red Crescent organization to help 1 million victims over a 60-day period. The program will include distributing clothing and dry foods; providing emergency and preventative medical care and purified water supplies; and rebuilding homes.

The United States, which has already provided \$134 million in aid to Bangladesh this year, will provide \$150 million to help combat the disaster. An \$84 million repayment made by Bangladesh for past aid received through the Food for Peace program was also returned by the United States. The State Department has shipped \$6 million worth of supplies, primarily grain, to Bangladesh; \$60 million in grain scheduled for shipment there next year is also being sent. Although it appears that enough food will reach Bangladesh,

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A Two-Part Report: A and B

NO. 37A

September 30, 1988

STATISTICAL PROFILE

JAPAN'S ECONOMY IN 1987
AND
INTERNATIONAL TRANSACTIONS OF JAPAN AND THE UNITED STATES IN 1987

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Table 1: Japan's Gross National Product at 1980 Constant Prices, 1983-1987

(in billions of yen, seasonally adjusted, quarterly figures at annual rates)

	<u>1983</u>	<u>1984</u>	<u>1985</u>	<u>1986</u>	<u>1987</u>
Gross National Product	Y264,703.7 (3.2%)	Y278,140.0 (5.1%)	Y291,806.9 (4.9%)	Y298,841.4 (2.4%)	Y311,641.4 (4.3%)
Personal Consumption Spending	153,781.5 (3.2%)	157,989.5 (2.7%)	162,326.4 (2.7%)	167,508.3 (3.2%)	173,960.0 (3.9%)
Private Residential Construction	13,917.2 (-6.2%)	13,641.3 (-2.0%)	13,981.9 (2.5%)	15,163.0 (8.4%)	18,288.2 (20.6%)
Private Fixed Nonresidential Investment	41,720.7 (2.7%)	46,506.8 (11.5%)	52,408.2 (12.7%)	55,607.2 (6.1%)	60,206.9 (8.3%)
Change in Business Inventories	795.8 (-53.9%)	1,402.2 (76.2%)	2,365.4 (68.7%)	852.5 (-64.0%)	737.9 (-13.4%)
Government Current Expenditures	25,838.2 (2.9%)	26,554.2 (2.8%)	27,011.8 (1.7%)	28,771.6 (6.5%)	28,614.8 (-0.5%)
Government Fixed Investment	23,052.2 (-1.6%)	22,405.2 (-2.8%)	20,960.1 (-6.4%)	21,797.8 (4.0%)	23,615.8 (8.3%)
Change in Government Inventories	-352.8 (*)	167.5 (*)	302.2 (*)	797.9 (*)	-12.8 (*)
Net External Sector	5,950.8 (184.1%)	9,473.3 (59.2%)	12,451.0 (31.4%)	8,343.1 (-33.0%)	6,230.5 (-25.3%)
Exports of Goods and Services and Factor Income Received	44,555.6 (4.2%)	52,351.8 (17.5%)	55,297.5 (5.6%)	52,397.0 (-5.2%)	54,331.1 (3.7%)
Imports of Goods and Services and Factor Income Paid	38,604.8 (-5.1%)	42,878.5 (11.1%)	42,846.5 (-0.1%)	44,053.8 (2.8%)	48,100.5 (9.2%)

(continued)

Table 1: Japan's Gross National Product at 1980 Constant Prices, 1983-1987 (continued)

(in billions of yen, seasonally adjusted, quarterly figures at annual rates)

	January- March 1986	April-June 1986	July- September 1986	October- December 1986	January- March 1987	April-June 1987	July- September 1987	October- December 1987
Gross National Product	¥294,744.4 (-2.2%)	¥297,492.8 (3.8%)	¥300,254.8 (3.8%)	¥302,299.0 (2.8%)	¥306,780.1 (6.1%)	¥306,805.8 (0.0%)	¥313,030.0 (8.4%)	¥318,776.3 (7.6%)
Personal Consumption Spending	164,806.3 (1.9%)	166,756.3 (4.8%)	169,587.0 (7.0%)	168,584.8 (-2.3%)	171,935.2 (8.2%)	173,089.9 (2.7%)	174,877.5 (4.2%)	175,663.0 (1.8%)
Private Residential Construction	14,354.9 (8.5%)	14,558.4 (5.8%)	15,455.2 (27.0%)	16,263.4 (22.6%)	16,459.1 (4.9%)	16,950.2 (12.5%)	18,679.1 (47.5%)	21,042.6 (61.1%)
Private Fixed Nonresidential Investment	54,968.9 (0.3%)	55,261.6 (2.2%)	55,561.6 (2.2%)	56,543.9 (7.3%)	57,949.6 (10.3%)	58,973.3 (7.3%)	60,554.5 (11.2%)	63,065.7 (17.7%)
Change in Business Inventories	1,505.2 (*)	460.3 (*)	547.6 (*)	885.7 (*)	143.9 (*)	906.7 (*)	716.3 (*)	1,172.2 (*)
Government Current Expenditures	27,486.1 (3.2%)	27,664.2 (2.6%)	27,972.4 (4.5%)	31,983.9 (70.9%)	28,384.9 (-38.0%)	28,726.6 (4.9%)	28,648.5 (-1.1%)	28,706.9 (0.8%)
Government Fixed Investment	20,985.6 (0.5%)	21,831.0 (17.1%)	22,068.2 (4.4%)	22,262.1 (3.6%)	22,417.9 (2.8%)	22,797.4 (7.0%)	23,496.0 (12.8%)	25,046.4 (29.1%)
Change in Government Inventories	135.9 (*)	3,302.0 (*)	1,635.3 (*)	-1,891.6 (*)	226.2 (*)	-102.2 (*)	-9.2 (*)	-163.3 (*)
Net External Sector	10,501.5 (-47.7%)	7,659.0 (-71.7%)	7,427.5 (-11.6%)	7,666.9 (13.5%)	9,263.3 (113.1%)	5,463.9 (-87.9%)	6,067.3 (52.0%)	4,242.8 (-76.1%)
Exports of Goods and Services and Factor Income Received	52,059.8 (-15.0%)	52,736.6 (5.3%)	52,454.2 (-2.1%)	52,147.6 (-2.3%)	53,451.0 (10.4%)	52,466.1 (-7.2%)	55,981.6 (29.6%)	55,472.2 (-3.6%)
Imports of Goods and Services and Factor Income Paid	41,558.3 (-3.0%)	45,077.7 (38.4%)	45,026.6 (-0.4%)	44,480.7 (-4.8%)	44,187.7 (-2.6%)	47,002.2 (28.0%)	49,914.3 (27.2%)	51,229.4 (11.0%)

*Cannot be calculated or meaningless.

Source: Economic Planning Agency

Table 2: Major Interest Rates in Japan, 1983-1987

(percent per annum)

	Central Bank Discount Rate*	Long-Term Prime Lending Rate*	Call Rate**	Average Interest Rate on Loans and Discounts of All Banks*	Savings Deposits*			
					Commercial Banks		Post Office	
					Ordinary Deposits	Six-Month Time Deposits	Ordinary Deposits	One-Year Savings Certificates
1983	5.0%	8.2%	6.39%	6.81%	1.75%	5.0%	3.12%	4.25%
1984	5.0	7.6	6.10	6.57	1.50	4.75	2.88	4.0
1985	5.0	7.2	6.46	6.47	1.50	4.75	2.88	4.0
1986	3.0	6.2	4.79	5.51	0.26	3.01	1.68	2.26
1987	2.5	3.7	3.51	4.94	0.26	2.64	1.68	2.26

*End of period.

**Average for period.

Source: Bank of Japan

Table 3: Money Supply in Japan, 1983-1987

(in billions of yen, average for period)

	<u>Outstanding Money Supply (M₂+CDs)*</u>	<u>Change</u>
1983	¥252,640	7.4%
1984	272,360	7.8
1985	295,183	8.4
1986	320,732	8.7
1987	354,036	10.4

*Includes currency in circulation, demand deposits and time deposits (excluding trust accounts) held by commercial banks, plus certificates of deposit.

Source: Bank of Japan

Table 4: Japan's General Account Expenditures (Revised), FY 1983-FY 1987*

(in billions of yen and percentage change)

	FY 1983		FY 1984		FY 1985		FY 1986		FY 1987	
Total Expenditures	¥50,839.4	6.9%	¥51,513.4	1.3%	¥53,222.9	3.3%	¥53,824.8	1.1%	¥58,214.2	8.2%
Social Security	9,231.3	1.0	9,683.9	4.9	9,830.8	1.5	10,090.3	2.6	10,321.8	2.3
Public Assistance	1,129.7	4.6	1,187.5	5.1	1,082.2	-8.9	1,110.4	2.6	1,105.2	-0.5
Social Welfare	1,917.5	19.6	2,013.2	5.0	2,056.2	2.1	1,977.8	-3.8	2,033.2	2.8
Social Insurance	5,378.9	-4.9	5,619.1	4.5	5,847.5	4.1	6,137.3	5.0	6,310.2	2.8
Health Services	435.4	0.3	485.8	11.6	464.4	-4.4	497.2	7.1	512.3	3.0
Unemployment Compensation	369.8	-1.1	378.3	2.3	380.5	0.6	367.6	-3.4	361.0	-1.8
Education and Science	4,834.3	0.0	4,920.3	1.8	4,904.3	-0.3	4,886.6	-0.4	5,063.7	3.6
Compulsory Education	2,254.5	1.5	2,368.8	5.1	2,415.2	2.0	2,414.9	-0.0	2,392.9	-0.9
Transfer to School Account	1,015.6	0.0	1,096.9	8.0	1,075.1	-2.0	1,083.7	0.8	1,180.1	8.9
Science and Technology Promotion	392.0	2.7	374.6	-4.4	375.4	0.2	381.8	1.7	473.5	24.0
School Facilities	489.8	-7.4	427.3	-12.8	385.5	-9.8	350.0	-9.2	354.6	1.3
School Aid	592.0	-0.5	566.6	-4.3	569.6	0.5	575.7	1.1	580.9	0.9
Student Loans	90.3	-0.5	86.2	-4.6	83.6	-3.0	80.5	-3.7	81.7	1.5
Public Works	7,224.3	-0.8	6,882.0	-4.7	6,922.3	0.6	6,946.3	0.3	7,428.0	6.9
Erosion and Flood Control	1,107.4	0.1	1,098.4	-0.8	1,082.8	-1.4	1,101.4	1.7	1,221.9	10.9
Road Improvement	1,893.3	0.1	1,899.9	0.3	1,856.1	-2.3	1,826.3	-1.6	1,983.8	8.6
Harbors and Airports	524.1	0.3	519.8	-0.8	511.9	-1.5	517.3	1.1	563.7	9.0
Housing	894.3	1.9	913.9	2.2	927.9	1.5	940.2	1.3	964.4	2.6
Social Infrastructure	988.2	0.1	980.3	-0.8	970.3	-1.0	989.0	1.9	1,106.1	11.8
Agricultural Infrastructure	900.0	0.0	892.1	-0.9	879.0	-1.5	886.9	0.9	963.7	8.7
Forestry and Industrial Water Supplies	177.1	-0.7	173.2	-2.2	169.6	-2.1	170.4	0.5	181.2	6.3
Disaster Reconstruction	728.4	-9.6	393.5	-46.0	514.0	30.6	503.5	-2.0	431.6	-14.3
Reserves	11.4	-3.1	10.9	-3.7	10.7	-2.2	11.3	5.6	11.8	3.6
Pensions	1,890.0	-0.1	1,885.8	-0.2	1,863.7	-1.2	1,850.1	-0.7	1,895.6	2.5
Civil Servants	132.7	-2.0	128.2	-3.4	124.8	2.8	121.4	-2.7	122.2	0.7
Veterans	1,603.6	0.9	1,601.1	-0.2	1,578.7	-1.4	1,562.6	-1.0	1,606.9	2.8
Other Pensions	143.1	-8.2	146.0	2.0	149.9	2.7	155.9	4.0	157.6	1.1
Administrative Costs	10.6	2.3	10.5	-0.9	10.4	-1.4	10.3	-0.1	8.9	-14.3
Local Finance	7,672.9	-3.8	9,219.0	20.2	9,690.1	5.1	9,734.7	0.5	11,086.2	13.9
Local Allocation Tax	7,315.1	-2.9	9,036.1	23.5	9,690.1	7.2	9,734.7	0.5	11,086.2	13.9
Interest Support and Special Grants	357.8	-18.9	182.9	-48.6	0.0	-100.0	0.0	0.0	0.0	0.0
National Debt Service	8,167.5	18.3	9,232.7	13.0	10,180.5	10.3	10,664.4	4.8	11,851.4	11.1
Defense	2,761.0	7.6	2,961.5	7.3	3,169.7	7.0	3,338.0	5.3	3,507.8	5.1
Economic Cooperation	498.2	4.9	540.9	8.6	581.2	7.5	600.5	3.3	661.3	10.1
Small Business Assistance	238.9	-2.2	230.4	-3.6	211.9	-8.0	225.6	6.5	263.2	16.6
Energy Support	557.4	-0.3	610.4	9.5	626.2	2.6	570.5	-8.9	496.8	-12.9
Food Agency Account	917.2	-8.8	808.6	-11.8	695.2	-14.0	613.8	-11.7	688.2	12.1
Miscellaneous	6,636.4	49.1	4,367.9	-34.2	4,346.9	-0.5	4,104.0	-5.6	4,292.2	4.6
Reserves	210.0	-8.7	170.0	-19.0	200.0	17.6	200.0	0.0	200.0	0.0
Industrial Investment Special Account	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	458.0	100.0

*Revised budget figures include the supplementary budget.

Source: Ministry of Finance

Table 5: Japan's Discretionary General Account Spending (Revised), FY 1983-FY 1987*

(in billions of yen and percentage change)

	FY 1983		FY 1984		FY 1985		FY 1986		FY 1987	
Total Expenditures	¥50,839.4	6.9%	¥51,513.4	1.3%	¥53,222.9	3.3%	¥53,824.8	1.1%	¥58,214.2	8.2%
Minus										
Debt Service and Transfers to Local Governments	15,482.7	7.2	18,268.9	18.0	19,870.6	8.8	20,399.1	2.7	22,937.6	12.4
Equals										
Discretionary Spending	35,356.8	6.8	33,244.5	-6.0	33,352.3	0.3	33,425.8	0.2	35,276.5	5.5

*Revised budget figures include the supplementary budget.

Source: Ministry of Finance

Table 6: Japan's General Account Revenues (Revised), FY 1983-FY 1987*

(in billions of yen and percentage change)

	FY 1983		FY 1984		FY 1985		FY 1986		FY 1987	
Total Revenues	¥50,839.4	6.9%	¥51,513.4	1.3%	¥53,222.9	3.3%	¥53,824.8	1.1%	¥58,214.2	8.2%
Tax and Stamp Revenues	31,902.0	4.7	34,835.0	9.2	38,145.0	9.5	39,440.0	3.4	43,087.0	9.3
Direct Taxes	23,835.0	5.8	26,193.0	9.9	28,579.0	9.1	29,469.0	3.1	31,703.0	7.6
Income Taxes	13,545.0	6.1	13,985.0	3.2	15,378.0	10.0	16,393.0	6.6	16,188.0	-1.3
Corporate Taxes	9,497.0	4.9	11,333.0	19.3	12,197.0	7.6	11,725.0	-3.9	13,722.0	17.0
Indirect Taxes and Stamp Revenues	8,067.0	1.4	8,642.0	7.1	9,566.0	10.7	9,971.0	4.2	11,384.0	14.2
Liquor Taxes	1,860.0	5.3	1,992.0	7.1	1,955.0	-1.9	1,974.0	1.0	2,042.0	3.4
Gasoline Taxes	1,601.0	-1.4	1,617.0	1.0	1,554.0	-3.9	1,572.0	1.2	1,596.0	1.5
Commodity Taxes	1,314.0	6.5	1,503.0	14.4	1,538.0	2.3	1,627.0	5.8	1,686.0	3.6
Monopoly Profits	1,004.2	31.8	1,024.6	2.0	6.6	-99.4	7.6	15.2	6.0	-21.1
Public Enterprise Receipts	15.1	5.1	15.4	1.4	15.0	3.2	16.7	5.0	17.5	4.8
Sale of Public Properties	82.7	22.8	92.3	11.7	157.9	71.1	134.5	-14.8	180.6	34.3
Miscellaneous	3,843.3	107.3	2,282.6	-40.6	2,254.0	-1.3	2,289.7	1.6	2,044.7	-10.7
Public Bonds	13,790.0	-3.9	12,865.0	-6.7	12,438.0	-3.3	11,495.0	-7.6	10,539.0	-8.3
Carryover Surplus	202.2	390.1	398.5	97.1	205.4	-49.5	441.3	114.8	2,339.4	430.1

*Revised budget figures include the supplementary budget.

Source: Ministry of Finance

Table 7: Uses and Sources of Japan's Fiscal Investment and Loan Program Outlays (Initial), FY 1983-FY 1987

(in billions of yen and percentage change)

	FY 1983		FY 1984		FY 1985		FY 1986		FY 1987	
Total Outlays	Y20,702.9	2.0%	Y21,106.6	1.9%	Y20,858.0	-1.2%	Y22,155.1	6.2%	Y23,731.3	7.1%
Housing	5,304.1	3.4	5,289.5	-0.3	5,289.3	-0.0	5,856.2	10.7	6,328.2	8.1
Other Social Infrastructure	2,764.8	-3.4	3,007.5	8.8	3,280.9	9.1	3,694.5	12.6	3,998.7	8.2
Welfare	652.0	-7.0	637.9	-2.1	595.7	-6.6	625.9	5.1	627.7	0.3
Education	783.0	2.6	777.1	-0.8	745.3	-4.1	678.2	-9.0	784.1	15.6
Small Business	3,942.2	0.9	3,968.3	0.7	3,764.4	-5.1	3,700.0	-1.7	3,985.6	7.7
Agriculture	963.0	6.2	1,034.8	7.5	890.6	-13.9	902.1	1.3	907.8	0.6
Land Conservation and Disaster Work	332.5	7.4	379.1	13.8	472.8	24.7	422.7	-10.6	493.0	16.6
Roads	1,583.7	7.5	1,711.7	8.1	1,826.4	6.7	2,024.4	10.8	2,363.0	16.7
Transportation and Communications	1,924.6	-1.2	1,887.6	-1.9	1,763.4	-6.6	2,015.1	14.3	2,264.1	12.4
Regional Development	511.4	-5.0	500.0	-2.2	511.2	2.2	566.1	10.7	657.7	16.2
Industry and Technology	626.2	-1.5	620.3	-0.9	603.3	-2.7	635.9	5.4	630.9	-0.8
Foreign Trade and Economic Cooperation	1,315.4	18.2	1,292.8	-1.7	1,114.7	-13.8	1,034.0	-7.2	690.5	-33.2
Total Revenues	Y24,402.9	2.6%	Y24,706.6	1.2%	Y25,858.0	4.7%	Y27,155.1	5.0%	Y31,081.3	14.5%
Industrial Investment Special Account	5.2	-72.5	4.8	-7.7	31.4	554.2	61.5	95.9	144.3	134.6
Trust Fund Bureau Fund	19,135.3	-2.2	18,905.2	-1.2	20,029.0	5.9	20,738.6	3.5	24,595.8	18.6
Postal Savings	7,900.0	0.0	6,900.0	-12.7	6,790.0	-7.2	7,000.0	9.4	7,900.0	12.9
Pension Contributions	4,100.0	-4.7	3,850.0	-6.1	3,950.0	2.6	4,300.0	8.9	4,450.0	3.5
Other Revenues	7,135.3	-3.2	8,155.2	14.3	9,679.0	18.7	9,438.6	-2.5	12,245.8	29.7
Postal Life Insurance Fund	2,354.4	18.8	2,586.6	9.9	2,587.6	0.0	3,145.0	21.5	3,941.2	25.3
Government-Guaranteed Bonds and Borrowings	2,908.0	31.0	3,210.0	10.4	3,210.0	0.0	3,210.0	0.0	2,400.0	-25.2

Source: Ministry of Finance

Table 8: Japan's Industrial Production Index by Sector, 1983-1987

(1985 = 100)

	Total		Mining	Manufacturing	Steel	Nonferrous Metals	Fabricated Metal Products	Nonelectric Machinery	Electric Machinery	Transport Equipment
	Index	Change								
1983	88.1	3.0%	99.5	88.0	89.0	94.3	96.3	80.9	72.7	87.5
1984	96.4	9.4	98.9	96.4	98.1	100.0	99.6	92.2	94.1	93.3
1985	100.0	3.7	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
1986	99.8	-0.2	99.6	99.8	94.4	100.0	99.7	95.6	104.2	98.1
1987	103.2	3.4	90.3	103.2	96.3	107.6	103.2	95.9	113.7	96.8

	Precision Instruments	Nonmetallic Mineral Products	Chemicals	Petroleum and Coal Products	Plastic Products	Pulp, Paper and Paper Products	Textiles	Food and Tobacco Products	Other
1983	77.5	96.2	89.3	102.7	90.8	91.6	99.0	101.5	98.8
1984	87.6	100.0	96.9	106.4	97.1	96.2	101.1	99.8	99.6
1985	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
1986	104.5	96.8	103.2	96.4	101.8	103.0	95.9	101.1	100.7
1987	105.4	100.3	111.1	92.9	106.7	109.2	94.4	101.9	103.9

Source: Ministry of International Trade and Industry

Table 9: Japan's Index of Industrial Production by End-Use Classification, 1983-1987

(1985 = 100)

	Final Demand Goods					Producer Goods
	Total	Capital Goods	Construction Materials	Consumer Goods		
				Durable	Nondurable	
1983	89.0	81.9	101.8	82.9	96.6	86.9
1984	94.8	92.8	101.2	89.8	98.3	98.4
1985	100.0	100.0	100.0	100.0	100.0	100.0
1986	100.6	99.0	99.8	102.3	101.9	98.7
1987	103.2	102.2	105.5	101.5	104.5	103.1

Source: Ministry of International Trade and Industry

Table 10: Japan's Index of Producers' Inventories of Finished Goods, 1983-1987

(1985 = 100)

	Total	Mining	Manufacturing	Steel	Nonferrous Metals	Fabricated Metal Products	Nonelectric Machinery	Electric Machinery	Transport Equipment
1983	92.1	99.2	92.1	92.1	86.8	104.8	82.5	76.0	93.4
1984	93.8	88.8	93.8	94.6	91.3	97.5	88.3	77.5	92.3
1985	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
1986	101.1	163.0	100.9	96.2	101.0	98.4	104.3	103.6	93.8
1987	97.4	264.3	96.9	89.4	93.6	100.6	95.4	98.8	92.4

	Precision Instruments	Nonmetallic Mineral Products	Chemicals	Petroleum and Coal Products	Plastic Products	Pulp, Paper and Paper Products	Textiles	Food and Tobacco Products	Other
1983	99.1	92.6	89.4	109.1	91.8	83.9	94.9	100.3	96.8
1984	90.2	92.0	94.9	106.8	95.1	90.4	93.2	106.5	98.8
1985	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
1986	118.8	104.4	102.3	99.4	100.5	104.6	103.3	99.4	99.1
1987	112.8	98.7	98.2	98.5	99.8	107.2	97.0	95.5	95.9

Source: Ministry of International Trade and Industry

Table 11: Japan's Index of Consumption of Materials, 1983-1987

(1985 = 100)

	Manufacturing	Steel	Non-ferrous Metals	Fabricated Metal Products	Machinery	Nonmetallic Mineral Products	Chemicals	Petroleum and Coal Products	Plastic Products	Pulp, Paper and Paper Products	Textiles	Other Industries
1983	91.7	90.3	96.5	101.4	85.4	99.8	90.5	102.9	93.2	93.1	99.6	100.5
1984	99.0	98.8	100.7	99.8	96.2	102.2	99.9	106.7	98.0	97.8	101.9	100.3
1985	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
1986	96.1	89.7	100.2	99.3	94.9	99.1	99.5	95.7	102.1	101.7	94.3	97.6
1987	97.6	90.4	104.7	104.9	95.2	102.9	105.7	93.1	108.3	106.9	94.0	101.1

Source: Ministry of International Trade and Industry

Table 12: Japan's Index of Inventories of Materials, 1983-1987

(1985 = 100)

	Manufacturing	Steel	Non-ferrous Metals	Fabricated Metal Products	Machinery	Nonmetallic Mineral Products	Chemicals	Petroleum and Coal Products	Plastic Products	Pulp, Paper and Paper Products	Textiles	Other Industries
1983	101.9	111.3	107.4	110.1	91.6	94.2	95.4	97.9	116.6	104.1	102.3	104.4
1984	101.9	104.7	106.0	103.4	100.0	97.1	101.2	98.9	107.9	105.3	103.1	100.0
1985	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
1986	95.1	98.2	77.7	92.2	89.1	94.9	99.6	99.6	89.7	94.8	93.4	99.6
1987	91.4	91.8	64.3	88.0	82.6	90.8	100.0	97.0	99.7	90.7	91.6	100.5

Source: Ministry of International Trade and Industry

Table 13: Japan's Index of Manufacturing Operating Rates, 1983-1987

(1985 = 100)

	Total	Steel	Non-ferrous Metals	Fabricated Metal Products	Nonelectric Machinery	Electric Machinery	Transport Equipment	Precision Instruments	Nonmetallic Mineral Products	Chemicals	Petroleum and Coal Products	Pulp, Paper and Paper Products	Textiles
1983	94.3	87.4	97.5	91.2	87.1	96.9	101.4	83.1	99.0	91.2	92.0	91.6	99.5
1984	99.8	97.1	101.6	97.5	99.5	103.6	99.6	95.0	98.4	98.9	107.4	96.0	99.9
1985	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
1986	95.4	93.9	98.8	98.5	87.7	92.4	95.9	95.2	96.7	99.9	95.9	102.8	99.1
1987	95.5	95.6	104.8	103.4	83.1	90.1	95.0	88.8	95.4	104.3	97.4	109.6	98.2

Source: Ministry of International Trade and Industry

Table 14: Residential Construction Starts in Japan, 1983-1987

(units)

	Total	Type of Housing		Owner-Occupant Relationship			
		Public	Private	Owner-Built	Developer-Built	Rental Units	Other
1983	1,136,797	94,909	1,041,888	478,833	243,265	394,495	20,204
1984	1,187,282	86,285	1,100,997	469,879	231,001	464,308	22,094
1985	1,236,072	81,305	1,154,767	464,697	224,018	527,042	20,315
1986	1,364,609	80,780	1,283,829	477,050	220,155	645,886	21,518
1987	1,674,300	80,719	1,593,581	546,316	246,861	858,726	22,397

Source: Ministry of Construction

Table 15: Japan's Labor Force Survey, 1983-1987

(in thousands of persons)

	Working-Age Population*	Total Labor Force	Employed Labor Force	Totally Unemployed Labor Force	Unemployment Rate	Not in Labor Force	Ratio of Job Offers to Applications**
1983	92,320	58,890	57,330	1,560	2.6%	33,050	0.60
1984	93,470	59,270	57,660	1,610	2.7	33,730	0.65
1985	94,650	59,630	58,070	1,560	2.6	34,500	0.68
1986	95,870	60,200	58,530	1,670	2.8	35,130	0.62
1987	97,200	60,840	59,110	1,730	2.8	35,840	0.70

*People 15 years old and over.

**Excludes applications by new school graduates but includes those by people seeking part-time work.

Source: Prime Minister's Office and Ministry of Labor

Table 16: Employment Index of Regular Workers in Japan, 1983-1987

(1985 = 100)

	Total	Mining	Construc- tion	Manufac- turing	Foods and Tobacco	Textiles	Apparel	Lumber and Wood Products	Pulp and Paper Products	Publish- ing	Chemicals	Petroleum and Coal Products	Nonmetallic Mineral Products	Steel
1983	96.8	110.0	104.6	95.7	99.8	106.8	97.5	112.1	98.6	96.1	101.1	107.8	101.9	104.2
1984	98.2	104.6	102.9	97.6	99.2	103.2	97.4	105.4	98.7	98.0	100.2	103.3	101.0	101.0
1985	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
1986	101.4	93.4	99.5	101.2	102.9	96.6	103.6	99.9	101.7	101.6	101.4	97.3	99.5	97.2
1987	102.0	87.3	101.9	99.7	104.5	94.6	103.0	103.2	101.8	103.3	102.4	92.0	98.9	91.8

	Non- ferrous Metals	Fabricat- ed Metal Products	Non- electric Machinery	Electric Machinery	Transport Equipment	Precision Instruments	Utilities	Trans- portation and Commu- nications	Wholesale and Retail Trade	Finance and Insurance	Real Estate	Services
1983	98.6	100.9	94.6	82.4	97.1	96.3	103.1	100.1	96.4	102.4	91.6	93.4
1984	100.0	99.8	96.9	91.6	97.9	98.2	101.4	100.1	98.2	101.1	96.2	96.2
1985	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
1986	99.6	101.0	102.4	103.1	99.5	99.5	100.6	98.8	102.4	100.4	102.2	103.2
1987	98.9	101.4	100.2	100.7	94.9	95.3	101.0	96.0	105.9	103.5	106.8	105.9

Source: Ministry of Labor

Table 17: Nominal Wage Index of Regular Workers in Japan, 1983-1987

(1985 = 100)

	Total	Mining	Construc- tion	Manufac- turing	Foods and Tobacco	Textiles	Apparel	Lumber and Wood Products	Pulp and Paper Products	Publish- ing	Chemicals	Petroleum and Coal Products	Nonmetallic Mineral Products	Steel
1983	93.9	93.8	92.7	93.5	96.8	94.6	97.3	91.7	90.6	93.4	93.1	88.8	93.4	92.3
1984	97.3	96.1	96.6	97.0	98.2	96.6	100.5	95.2	95.6	95.4	97.2	94.5	96.8	95.4
1985	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
1986	102.7	99.1	104.3	101.5	105.2	102.1	100.8	104.9	101.7	104.7	102.6	103.3	103.3	100.1
1987	104.7	100.3	107.1	103.2	106.8	105.6	103.2	109.0	103.8	105.0	106.2	106.5	105.7	98.4

	Non- ferrous Metals	Fabricat- ed Metal Products	Non- electric Machinery	Electric Machinery	Transport Equipment	Precision Instruments	Utilities	Trans- portation and Commu- nications	Wholesale and Retail Trade	Finance and Insurance	Real Estate	Services
1983	91.3	93.4	92.1	95.3	92.0	92.0	92.3	95.3	95.4	91.0	93.9	93.6
1984	95.5	97.6	96.6	99.3	96.2	94.5	96.1	98.3	98.5	95.2	98.0	96.9
1985	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
1986	102.7	103.5	99.4	100.4	100.7	100.4	105.2	102.1	102.7	105.1	105.7	103.7
1987	105.4	104.4	100.6	103.7	101.0	101.2	107.5	105.9	104.2	108.0	109.1	104.8

Source: Ministry of Labor

Table 18: Average Monthly Wages of Manufacturing Employees in Japan by Industry, 1983-1987

(in thousands of yen)

	Total	Foods and Tobacco	Textiles	Pulp and Paper Products	Chemicals	Nonmetallic Mineral Products	Steel	Non- ferrous Metals	Fabricat- ed Metal Products	Non- electric Machinery	Electric Machinery	Transport Equipment	Precision Instruments
1983	Y279.1	Y226.2	Y198.1	Y283.1	Y357.9	Y272.7	Y359.9	Y309.4	Y269.2	Y313.6	Y267.3	Y316.5	Y265.4
1984	292.3	233.7	202.2	301.4	376.3	284.7	373.5	324.3	282.7	330.8	281.7	333.6	274.0
1985	299.5	235.5	211.9	314.6	389.6	289.0	391.7	336.4	287.8	337.6	280.7	345.1	287.4
1986	305.4	250.6	216.9	322.0	402.8	299.2	392.1	345.1	298.5	334.9	283.6	348.3	288.9
1987	313.2	259.6	224.2	331.7	419.2	308.1	385.2	354.6	302.6	340.7	296.2	352.4	292.2

Note: Includes overtime pay and bonuses.

Source: Ministry of Labor

Table 19: Index of Labor Productivity in Japan, 1983-1987

(1985 = 100)

	Total	Mining	Manufacturing	Foods	Textiles	Lumber and Wood Products	Pulp and Paper Products	Nonmetallic Mineral Products	Rubber Products	Chemicals
1983	88.2	94.8	88.2	102.7	93.8	95.8	88.7	92.4	93.6	88.8
1984	95.8	95.8	95.8	101.0	98.4	95.2	94.3	97.9	97.0	96.5
1985	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
1986	101.9	108.4	101.8	101.4	100.8	112.9	105.7	99.8	99.7	104.2
1987	107.8	123.8	107.7	100.4	102.5	107.3	113.3	105.6	104.9	113.2

	Plastic Products	Petroleum and Coal Products	Steel	Nonferrous Metals	Fabricated Metal Products	Nonelectric Machinery	Electric Machinery	Transport Equipment	Precision Instruments
1983	92.9	93.6	85.6	94.8	94.6	83.3	79.4	87.1	76.5
1984	98.0	101.9	96.0	98.8	93.8	93.1	95.5	93.8	87.3
1985	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
1986	100.2	103.5	97.9	101.2	102.1	97.3	102.9	101.0	109.1
1987	105.6	107.4	107.1	109.1	108.4	102.8	114.5	102.9	118.1

Source: Japan Productivity Center

Table 20: Japan's Consumer Price Index, 1983-1987

(1985 = 100)

	Total		Food	Housing	Utilities	Furniture and Housewares	Clothing	Medical Care	Transport- ation	Education	Recreation	Miscella- neous
	Index	Change										
1983	95.8	1.8%	95.6	95.4	100.5	98.5	94.3	91.2	97.0	91.7	96.1	96.5
1984	98.0	2.3	98.3	97.5	100.4	99.3	96.7	94.5	97.9	95.7	98.0	98.7
1985	100.0	2.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
1986	100.6	0.6	100.2	102.5	95.0	100.0	102.2	101.9	99.3	103.6	101.5	102.0
1987	100.7	0.1	99.3	105.4	88.0	99.4	103.3	103.8	100.0	107.1	102.0	103.2

Source: Management and Coordination Agency

Table 21: Japan's Wholesale Price Index by Industry, 1983-1987

(1985 = 100)

	Total		Foods	Textiles	Lumber and Wood Products	Pulp, Paper and Paper Products	Chemicals	Plastic Products	Petroleum and Products	Nonmetallic Mineral Products	Steel	Nonferrous Metals
	Index	Change										
1983	101.4	-2.2%	96.8	99.2	102.5	98.2	103.7	98.9	107.1	102.7	100.6	107.5
1984	101.1	-0.3	99.8	101.1	100.5	101.8	102.1	100.1	100.6	103.0	101.4	105.0
1985	100.0	-1.1	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
1986	90.9	-9.1	99.4	91.8	95.2	96.3	89.4	95.6	76.9	98.1	90.1	83.2
1987	87.5	-3.7	98.5	90.5	105.0	94.5	85.7	92.1	64.3	96.5	86.9	83.1

	Metal Products	Nonelectric Machinery	Electric Machinery	Transport Equipment	Precision Instruments	Miscellaneous Manufactures	Agricultural, Forestry and Fishery Products	Mining Products	Utilities
1983	96.9	99.7	103.9	99.2	101.5	99.8	103.9	104.2	98.8
1984	99.9	99.8	102.7	100.2	100.3	100.9	104.3	99.5	99.7
1985	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
1986	98.4	96.3	89.8	94.8	98.2	97.3	91.0	56.4	95.3
1987	95.6	93.8	84.3	92.6	97.4	95.3	86.7	50.8	89.0

Source: Bank of Japan

Table 22: Japan's Wholesale Price Index by End-Use Classification, 1983-1987

(1985 = 100)

	Domestic Products										Exports			
	Intermediate Goods										Semi-finished Goods			
	Total	Raw Materials	Total	Semi-finished Goods	Construction Materials	Fuels and Energy	Capital Goods	Consumer Goods			Total	Semi-finished Goods	Capital Goods	Consumer Goods
								Total	Durables	Nondurables				
1983	101.5	104.5	102.1	102.4	100.2	104.5	99.9	99.4	100.7	99.0	100.8	102.1	99.1	101.4
1984	101.1	101.9	101.6	102.5	101.3	100.1	99.9	100.0	100.3	99.9	101.5	102.5	100.0	101.8
1985	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
1986	91.8	66.5	92.0	91.3	97.5	85.6	97.7	98.0	97.4	98.1	84.9	80.0	89.2	87.0
1987	88.5	62.4	88.2	87.7	98.7	74.7	95.5	95.7	94.5	96.2	80.6	75.7	85.2	82.7

Source: Bank of Japan

Table 23: Japan's Global Balance of Payments, 1983-1987

(in millions of dollars, IMF value basis, seasonally unadjusted)

	Trade Balance	Exports	Imports	Services	Transfers	Current Account Balance	Long- Term Capital	Basic Balance	Short- Term Capital	Errors and Omissions	Overall Balance	Gold and Foreign Exchange Reserves*
1983	\$31,454	\$145,468	\$114,014	\$-9,106	\$-1,549	\$20,799	\$-17,700	\$3,099	\$23	\$2,055	\$5,177	\$24,496
1984	44,257	168,290	124,033	-7,747	-1,507	35,003	-49,651	-14,648	-4,295	3,743	-15,200	26,313
1985	55,986	174,015	118,029	-5,165	-1,652	49,169	-64,542	-15,373	-936	3,991	-12,318	26,510
1986	92,827	205,591	112,764	-4,932	-2,050	85,845	-131,461	-45,616	-1,609	2,458	-44,767	42,239
1987	96,386	224,605	128,219	-5,702	-3,669	87,015	-136,532	-49,517	23,865	-3,893	-29,545	81,479
1986 January	2,360	12,614	10,254	-285	-145	1,930	-7,241	-5,311	-1,094	1,253	-5,152	26,961
February	4,770	14,889	10,119	-693	-185	3,892	-8,061	-4,169	1,601	1,269	-1,299	27,582
March	7,422	17,310	9,888	-167	-409	6,846	-3,688	3,158	-1,623	-779	756	27,917
April	7,742	17,485	9,743	215	-177	7,780	-12,122	-4,342	-637	3,644	-1,335	31,113
May	8,340	17,633	9,293	-561	-150	7,625	-9,916	-2,287	1,085	340	-862	32,475
June	7,840	17,152	9,312	-28	-122	7,690	-6,844	846	-1,917	-1,359	-2,430	33,905
July	8,759	18,493	9,734	-499	-175	8,085	-11,812	-3,727	1,401	1,697	-629	38,330
August	8,178	16,627	8,449	-934	-158	7,086	-13,043	-5,957	-1,620	2,105	-5,472	41,214
September	9,856	18,739	8,883	-489	-125	9,242	-13,555	-4,313	1,726	-1,285	-3,872	41,456
October	8,817	18,861	10,044	-454	-112	8,251	-16,248	-7,997	98	-182	-8,081	41,676
November	8,548	16,591	8,043	-242	-83	8,223	-13,594	-5,371	201	-4,163	-9,333	41,980
December	10,195	19,197	9,002	-795	-209	9,191	-15,337	-6,146	-830	-82	-7,058	42,239
1987 January	5,703	14,646	8,943	-637	-225	4,841	-12,461	-7,620	1,581	-997	-7,036	51,459
February	8,284	16,848	8,564	-510	-140	7,634	-11,441	-3,807	-1,346	2,503	-2,650	51,730
March	9,386	19,021	9,635	-201	-698	8,487	-8,307	180	1,157	3,477	4,814	58,389
April	8,886	19,236	10,350	-496	-238	8,152	-12,393	-4,241	2,131	316	-1,794	68,620
May	8,110	18,154	10,044	-854	-144	7,112	-12,778	-5,666	1,304	2,911	-1,451	68,935
June	8,042	18,433	10,391	-251	-293	7,498	-19,194	-11,696	3,025	-2,541	-11,212	69,273
July	8,581	19,535	10,954	-1,057	-240	7,284	-18,515	-11,231	1,770	-1,346	-10,807	69,769
August	6,183	17,183	11,000	-597	-190	5,396	-1,134	4,262	5,342	-309	9,295	70,726
September	8,821	19,882	11,061	-103	-209	8,509	-2,374	6,135	2,721	866	9,722	72,139
October	7,737	20,121	12,384	-807	-196	6,734	-18,649	-11,915	913	-3,568	-14,570	73,050
November	6,695	18,664	11,969	116	-878	5,933	-14,119	-8,186	6,509	-3,743	-5,420	78,044
December	9,958	22,882	12,924	-305	-218	9,435	-5,167	4,268	-1,242	-1,462	1,564	81,479

*End of period.

Note: For capital transactions, credits (+) indicate net inflows and debits (-) indicate net outflows.

Source: Bank of Japan and Ministry of Finance

Table 24: Japan's Balance of Payments with the United States, 1983-1987

(in millions of dollars, IMF value basis)

	1983	1984	1985	1986	1987
Merchandise Trade Balance	\$21,211	\$36,704	\$42,988	\$54,919	\$57,117
Exports	43,057	60,479	65,617	80,385	83,010
Imports	21,846	23,775	22,629	25,466	25,893
Services Balance	-1,884	-1,495	-1,012	-585	1,021
Transportation	-573	-37	110	243	-698
Travel	-1,319	-1,369	-1,329	-2,012	-3,106
Investment Income	1,280	1,379	2,268	3,231	7,300
Other	-1,272	-1,468	-2,061	-2,047	-2,475
Official	1,314	1,397	1,495	1,931	1,751
Private	-2,586	-2,865	-3,556	-3,978	-4,226
Unilateral Transfers Balance	-176	-191	-249	-552	-1,460
Official	-18	-44	-27	-92	-779
Private	-158	-147	-222	-460	-681
Current Account Balance	19,151	35,018	41,727	53,782	56,678
Long-Term Capital (net)	-5,541	-14,814	-33,163	-65,650	-61,030
Direct Investments (net)	-1,041	-3,180	-2,043	-7,774	-9,018
Trade Credits (net)	-190	-195	-587	-334	-489
Loans (net)	-329	-477	-716	-690	-1,663
Stocks (net)	-3,803				
Bonds (net)	-140	-10,591	-29,874	-55,944	-48,223
Other (net)	-38	-371	57	-908	-1,637
Basic Balance	13,610	20,204	8,564	-11,868	-4,352

Note: For long-term capital transactions, credits (+) indicate net inflows and debits (-) indicate net outflows.

Source: Bank of Japan

Table 25: Japan's Exports and Imports in Dollar Terms, 1983-1987

(in millions of dollars, customs clearance basis, seasonally unadjusted)

	Exports (f.o.b.)	Change Over Year-Earlier Period	Imports (c.i.f.)	Change Over Year-Earlier Period	Trade Balance
1983	\$146,928	5.8%	\$126,393	-4.2%	\$20,534
1984	170,114	15.8	136,503	8.0	33,611
1985	175,638	3.3	129,539	-5.1	46,099
1986	209,151	19.1	126,408	-2.4	82,743
1987	229,221	9.6	149,515	18.3	79,706
1986 January	12,789	15.7	10,905	2.9	1,884
February	15,072	16.6	11,133	5.2	3,939
March	17,639	21.5	10,967	-3.2	6,672
April	17,758	19.4	10,908	-6.1	6,850
May	17,917	24.1	10,384	-6.1	7,533
June	17,492	21.1	10,133	7.5	7,359
July	18,887	23.5	10,694	0.0	8,193
August	16,830	21.4	9,354	-9.8	7,476
September	19,051	29.1	10,105	-0.7	8,946
October	19,144	19.4	11,373	-2.6	7,771
November	16,911	9.2	9,510	-11.2	7,401
December	19,663	9.5	10,943	-3.3	8,720
1987 January	14,911	16.6	10,600	-2.8	4,311
February	17,240	14.4	10,113	-9.2	7,127
March	19,314	9.5	11,263	2.7	8,050
April	19,499	9.8	11,964	9.7	7,536
May	18,615	3.9	12,197	17.5	6,417
June	18,817	7.6	12,219	20.6	6,598
July	19,894	5.3	12,957	21.2	6,938
August	17,604	4.6	12,457	33.2	5,147
September	20,357	6.9	12,932	28.0	7,425
October	20,661	7.9	13,865	21.9	6,796
November	18,938	12.0	14,187	49.2	4,751
December	23,372	18.9	14,760	34.9	8,612

Source: Ministry of Finance

Table 26: Japan's Exports and Imports in Yen Terms, 1983-1987

(in billions of yen, customs clearance basis, seasonally unadjusted)

	Exports (f.o.b.)	Change Over Year-Earlier Period	Imports (c.i.f.)	Change Over Year-Earlier Period	Trade Balance
1983	¥34,909	1.4%	¥30,015	-8.1%	¥4,895
1984	40,325	15.5	32,321	7.7	8,004
1985	41,956	4.0	31,085	-3.8	10,871
1986	35,290	-15.9	21,551	-30.7	13,739
1987	33,315	-5.6	21,737	0.9	11,578
1986 January	2,584	-7.6	2,204	-17.5	380
February	2,913	-12.3	2,155	-20.7	759
March	3,177	-16.0	1,976	-33.1	1,201
April	3,173	-16.1	1,948	-34.1	1,225
May	2,988	-17.7	1,735	-37.6	1,253
June	2,957	-18.2	1,715	-27.3	1,242
July	3,076	-18.2	1,745	-33.7	1,331
August	2,609	-20.9	1,450	-41.2	1,159
September	2,948	-16.6	1,563	-35.8	1,385
October	2,953	-17.1	1,754	-32.2	1,199
November	2,712	-16.4	1,525	-31.9	1,187
December	3,201	-12.1	1,781	-22.3	1,420
1987 January	2,362	-8.6	1,686	-23.5	677
February	2,635	-9.6	1,544	-28.3	1,091
March	2,963	-6.7	1,729	-12.5	1,235
April	2,863	-9.8	1,758	-9.8	1,105
May	2,606	-12.8	1,707	-1.6	899
June	2,685	-9.2	1,742	1.6	943
July	2,942	-4.3	1,915	9.8	1,027
August	2,655	1.8	1,879	29.6	776
September	2,910	-1.3	1,850	18.3	1,060
October	2,986	1.1	2,005	14.3	981
November	2,619	-3.4	1,965	28.9	654
December	3,090	-3.5	1,958	9.9	1,132

Source: Ministry of Finance

Table 27: Japan's Export and Import Quantum (Volume) Indexes,
1983-1987

(1980 = 100)

	Exports			Imports	
	Index	Change Over Year-Earlier Period		Index	Change Over Year-Earlier Period
1983	116.8	8.7%	98.1	1.3%	
1984	134.8	15.4	108.6	10.7	
1985	141.2	4.7	108.8	0.2	
1986	139.2	-1.4	123.3	13.3	
1987	136.7	-1.8	132.6	7.5	
1986 January	112.6	2.2	109.4	2.8	
February	129.1	0.1	112.2	5.8	
March	146.2	-2.3	117.1	2.2	
April	144.6	-0.3	126.9	7.3	
May	141.3	-0.1	126.5	13.6	
June	139.9	-2.2	125.0	32.4	
July	149.3	-0.9	130.2	21.1	
August	129.4	-3.5	118.3	13.5	
September	148.5	3.4	125.7	21.3	
October	147.1	-1.1	138.7	17.9	
November	128.9	-7.7	115.7	7.0	
December	153.2	-3.9	134.1	17.7	
1987 January	113.8	1.1	126.9	16.0	
February	128.2	-0.7	114.6	2.1	
March	145.3	-0.6	124.8	6.6	
April	140.9	-2.6	131.7	3.8	
May	132.9	-5.9	130.6	3.2	
June	135.2	-3.4	129.9	3.9	
July	142.7	-4.4	135.9	4.4	
August	127.4	-1.5	130.8	10.6	
September	144.5	-2.7	132.7	5.6	
October	146.7	-0.3	141.9	2.3	
November	129.3	0.3	142.8	23.4	
December	153.4	0.1	148.1	10.4	

Source: Ministry of Finance

Table 28: Japan's Export and Import Yen-Based Price Indexes,
1983-1987

(1985 = 100)

	Exports			Imports	
	Index	Change Over Year-Earlier Period		Index	Change Over Year-Earlier Period
1983	100.8	-6.1%	106.1	-7.8%	
1984	101.5	0.7	102.5	-3.4	
1985	100.0	-1.5	100.0	-2.4	
1986	84.9	-15.1	64.2	-35.8	
1987	80.6	-5.1	58.9	-8.3	
1986 January	91.5	n.a.	87.9	n.a.	
February	88.2	n.a.	81.8	n.a.	
March	87.1	n.a.	73.0	n.a.	
April	86.2	n.a.	67.5	n.a.	
May	84.1	n.a.	62.2	n.a.	
June	84.6	-17.3	61.1	-40.9	
July	82.6	-18.0	56.9	-43.6	
August	81.5	-18.2	53.5	-45.8	
September	81.9	-17.0	54.1	-44.6	
October	82.6	-12.4	56.1	-39.1	
November	84.4	-8.0	57.8	-34.8	
December	84.4	-7.2	58.3	-33.8	
1987 January	82.7	-9.6	58.1	-33.9	
February	82.1	-6.9	58.8	-28.1	
March	81.8	-6.1	59.0	-19.2	
April	79.7	-7.5	57.3	-15.1	
May	78.8	-6.3	57.2	-8.0	
June	80.3	-5.1	58.5	-4.3	
July	82.3	-0.4	60.6	6.5	
August	81.8	0.4	61.0	14.0	
September	80.6	-1.6	60.1	11.1	
October	80.7	-2.3	60.6	8.0	
November	79.1	-6.3	58.9	1.9	
December	77.5	-8.2	57.2	-1.9	

Source: Bank of Japan

Table 29: Japan's Exports by Major Market, 1983-1987

(in millions of dollars, f.o.b. value basis)

	1983	1984	1985	1986	1987
<u>Total Exports</u>	<u>\$146,928</u>	<u>\$170,114</u>	<u>\$175,638</u>	<u>\$209,151</u>	<u>\$229,221</u>
<u>Developed Countries</u>	<u>76,563</u>	<u>96,421</u>	<u>102,468</u>	<u>131,149</u>	<u>142,883</u>
United States	42,829	59,937	65,278	80,456	83,580
Canada	3,625	4,297	4,520	5,526	5,611
Western Europe	23,129	23,999	25,199	37,483	45,555
United Kingdom	4,983	4,675	4,723	6,647	8,400
Netherlands	1,726	1,816	2,071	3,261	4,071
Belgium	1,325	1,339	1,477	2,198	2,697
France	2,010	1,935	2,083	3,152	4,014
West Germany	5,877	6,621	6,938	10,477	12,833
Spain	587	528	605	1,076	1,343
Italy	875	1,032	1,117	1,723	2,103
European Community	18,523	19,405	20,016	30,675	37,693
Sweden	798	1,009	1,094	1,438	1,931
Switzerland	1,144	1,089	1,161	1,887	2,266
Australia	4,280	5,184	5,379	5,227	5,146
New Zealand	962	1,163	1,072	1,103	1,128
South Africa	1,738	1,840	1,020	1,355	1,863
<u>Developing Countries</u>	<u>61,435</u>	<u>53,092</u>	<u>56,978</u>	<u>63,934</u>	<u>74,402</u>
<u>Latin America</u>	<u>6,391</u>	<u>8,549</u>	<u>8,486</u>	<u>9,495</u>	<u>8,760</u>
Mexico	579	888	994	1,032	1,389
Panama	2,169	3,444	3,326	3,197	2,416
Brazil	738	640	615	973	879
<u>Southeast Asia</u>	<u>34,548</u>	<u>36,795</u>	<u>33,248</u>	<u>41,788</u>	<u>52,982</u>
Korea	6,004	7,227	7,097	10,475	13,229
Taiwan	5,086	5,986	5,026	7,852	11,346
Hong Kong	5,289	6,559	6,509	7,161	8,872
Thailand	2,507	2,426	2,030	2,030	2,953
Singapore	4,448	4,610	3,861	4,577	6,008
Malaysia	2,771	2,875	2,168	1,708	2,168
Brunei	86	72	90	58	41
Philippines	1,744	1,080	937	1,088	1,415
Indonesia	3,552	3,073	2,173	2,662	2,990
India	1,431	1,168	1,596	2,099	1,957
<u>Middle East and North Africa</u>	<u>17,160</u>	<u>14,206</u>	<u>12,171</u>	<u>9,795</u>	<u>9,177</u>
Iran	2,820	1,692	1,348	1,145	1,043
Iraq	632	806	1,306	1,210	391
Saudi Arabia	6,687	5,634	3,890	2,762	3,239
Kuwait	1,763	1,432	1,536	1,220	857
Qatar	233	175	164	148	151
Oman	469	508	554	288	262
United Arab Emirates	1,357	1,126	1,164	1,033	1,118
<u>Subsaharan Africa</u>	<u>2,906</u>	<u>2,998</u>	<u>2,519</u>	<u>2,178</u>	<u>2,894</u>
<u>Communist Countries</u>	<u>8,830</u>	<u>10,602</u>	<u>16,190</u>	<u>14,064</u>	<u>11,924</u>
China	4,912	7,217	12,478	9,856	8,250
U.S.S.R.	2,821	2,518	2,751	3,150	2,563

Source: Ministry of Finance

Table 30: Japan's Imports by Major Supplier, 1983-1987

(in millions of dollars, c.i.f. value basis)

	1983	1984	1985	1986	1987
<u>Total Imports</u>	<u>\$126,393</u>	<u>\$136,503</u>	<u>\$129,539</u>	<u>\$126,408</u>	<u>\$149,515</u>
<u>Developed Countries</u>	<u>49,325</u>	<u>54,740</u>	<u>53,121</u>	<u>62,233</u>	<u>71,610</u>
United States	24,648	26,862	25,793	29,054	31,491
Canada	4,430	4,945	4,773	4,895	6,073
Western Europe	11,087	13,091	12,356	18,118	22,749
United Kingdom	1,940	2,267	1,817	3,573	3,057
Netherlands	443	434	439	577	757
Belgium	376	469	482	677	859
France	1,302	1,236	1,324	1,855	2,871
West Germany	2,414	2,684	2,928	4,298	6,150
Spain	397	420	350	297	357
Italy	981	1,049	1,050	1,495	2,135
European Community	8,120	9,334	8,893	13,989	17,670
Sweden	452	473	441	575	682
Switzerland	1,412	1,965	1,758	2,571	3,101
Australia	6,642	7,296	7,452	6,980	7,869
New Zealand	932	935	903	956	1,168
South Africa	1,587	1,611	1,844	2,229	2,259
<u>Developing Countries</u>	<u>70,060</u>	<u>73,778</u>	<u>67,936</u>	<u>55,941</u>	<u>67,277</u>
Latin America	6,462	7,230	6,242	6,194	6,356
Mexico	1,889	2,260	1,870	1,439	1,625
Panama	68	168	81	84	69
Brazil	1,669	1,991	1,840	1,875	2,032
Southeast Asia	27,988	31,883	30,264	29,489	38,627
Korea	3,365	4,213	4,092	5,292	8,076
Taiwan	2,622	3,204	3,386	4,691	7,128
Hong Kong	670	842	767	1,074	1,561
Thailand	1,019	1,040	1,027	1,391	1,796
Singapore	1,468	1,775	1,594	1,463	2,048
Malaysia	3,131	4,412	4,330	3,846	4,772
Brunei	2,367	2,203	1,892	1,285	1,184
Philippines	1,307	1,419	1,243	1,221	1,353
Indonesia	10,432	11,176	10,119	7,311	8,427
India	1,131	1,132	1,189	1,297	1,530
Middle East and North Africa	33,796	33,066	29,927	18,427	20,197
Iran	4,231	2,869	2,506	1,383	1,556
Iraq	141	172	622	957	676
Saudi Arabia	15,530	14,734	10,245	5,205	7,311
Kuwait	1,387	1,589	1,162	1,157	1,796
Qatar	1,701	2,594	2,185	1,127	880
Oman	2,012	2,420	3,066	1,616	1,414
United Arab Emirates	7,793	7,720	8,916	5,947	5,408
Subsaharan Africa	1,345	1,166	1,052	1,356	1,435
<u>Communist Countries</u>	<u>7,004</u>	<u>7,982</u>	<u>8,480</u>	<u>8,232</u>	<u>10,628</u>
China	5,087	5,958	6,483	5,652	7,401
U.S.S.R.	1,456	1,394	1,429	1,972	2,352

Source: Ministry of Finance

Table 31: Japan's Trade Balance with Major Trading Partners, 1983-1987

(in millions of dollars; exports f.o.b., imports c.i.f.)

	1983	1984	1985	1986	1987
Overall Balance	\$20,534	\$33,611	\$46,099	\$82,743	\$79,706
<u>Developed Countries</u>	27,239	41,680	49,347	68,917	71,273
United States	18,181	33,075	39,485	51,401	52,090
Canada	-805	-648	-253	631	-462
Western Europe	12,042	10,908	12,843	19,365	22,806
United Kingdom	3,043	2,408	2,906	3,073	5,343
Netherlands	1,283	1,381	1,632	2,684	3,314
Belgium	948	870	995	1,521	1,837
France	708	700	759	1,297	1,143
West Germany	3,464	3,937	4,010	6,180	6,682
Spain	190	108	256	779	987
Italy	-106	-17	67	228	-32
European Community	10,402	10,071	11,124	16,687	20,024
Sweden	346	537	653	864	1,250
Switzerland	-269	-876	-597	-684	-835
Australia	-2,362	-2,112	-2,073	-1,754	-2,723
New Zealand	31	228	169	147	-41
South Africa	151	229	-824	-874	-396
<u>Developing Countries</u>	-8,625	-10,686	-10,958	7,993	7,126
Latin America	-71	1,318	2,244	3,301	2,405
Mexico	-1,310	-1,372	-876	-407	-236
Panama	2,101	3,276	3,245	3,113	2,348
Brazil	-931	-1,351	-1,225	-902	-1,154
Southeast Asia	6,560	4,912	2,984	12,299	14,355
Korea	2,639	3,014	3,005	5,183	5,154
Taiwan	2,463	2,782	1,640	3,161	4,218
Hong Kong	4,619	5,717	5,742	6,087	7,312
Thailand	1,488	1,385	1,004	639	1,157
Singapore	2,981	2,835	2,267	3,113	3,961
Malaysia	-360	-1,537	-2,162	-2,137	-2,604
Brunei	-2,281	-2,131	-1,802	-1,227	-1,143
Philippines	437	-339	-307	-133	62
Indonesia	-6,380	-8,102	-7,947	-4,649	-5,437
India	300	35	408	802	427
Middle East and North Africa	-16,636	-18,861	-17,766	-8,632	-11,020
Iran	-1,412	-1,177	-1,158	-239	-512
Iraq	491	634	684	253	-285
Saudi Arabia	-8,843	-9,100	-6,355	-2,443	-4,072
Kuwait	375	-157	374	63	-939
Qatar	-1,468	-2,419	-2,021	-979	-729
Oman	-1,544	-1,912	-2,512	-1,328	-1,152
United Arab Emirates	-6,436	-6,594	-7,752	-4,915	-4,290
Subsaharan Africa	1,561	1,833	1,466	822	1,459
<u>Communist Countries</u>	1,926	2,620	7,710	5,832	1,297
China	-175	1,259	5,995	4,204	848
U.S.S.R.	1,365	1,124	1,321	1,178	211

Source: Ministry of Finance

Table 32: Japan's Exports by Commodity, 1983-1987

(in millions of dollars, f.o.b. value basis)

	1983	1984	1985	1986	1987
Total Exports	\$146,928	\$170,114	\$175,638	\$209,151	\$229,221
Food and Live Animals	1,246	1,290	1,202	1,366	1,424
Fish and Fish Products	663	717	685	766	732
Beverages and Tobacco	144	150	114	110	121
Crude Materials (excl. fuels)	2,194	2,250	1,240	1,414	1,490
Textile Fibers and Waste	644	659	635	693	708
Mineral Fuels	432	405	539	588	782
Petroleum Products	249	289	331	379	550
Animal and Vegetable Oils and Fats	118	148	111	91	85
Chemicals	6,983	7,626	7,698	9,484	11,662
Chemical Elements and Compounds	2,943	3,121	3,243	3,953	4,979
Organic Chemicals	2,197	2,371	2,512	3,141	4,017
Inorganic Chemicals	755	738	720	799	941
Dyeing, Tanning and Coloring Materials	501	558	558	707	857
Pharmaceuticals	348	356	391	513	589
Plastic Materials	2,439	2,351	2,261	2,843	3,406
Manufactured Goods Classified Mainly by Material	28,935	30,137	28,836	29,600	30,126
Tires and Other Rubber Manufactures	1,823	1,973	1,895	2,040	2,240
Tires for Motor Vehicles	1,267	1,382	1,302	1,642	1,515
Paper and Paper Products	872	994	1,029	1,184	1,407
Textiles (excl. fibers and apparel)	5,341	5,318	4,900	5,445	5,545
Yarn and Thread	1,122	1,168	1,000	1,152	1,118
Woven Fabrics	3,626	3,546	3,361	3,706	3,742
Made-up Articles (excl. clothing)	593	604	540	586	686
Nonmetallic Mineral Manufactures	2,150	2,272	2,148	2,362	2,523
Glass and Glassware	422	518	594	686	803
Tableware	518	569	528	566	556
Iron and Steel	12,843	13,852	13,566	12,706	12,610
Bars, Rods, Shapes and Sections	1,816	1,715	1,777	1,437	1,059
Wire Rods	529	626	568	639	629
Universals, Plates and Sheets	5,339	5,706	5,209	5,250	6,078
Hoops and Strip	1,309	1,468	1,285	1,325	1,474
Tubes, Pipes and Fittings	3,370	3,742	4,027	3,399	2,843
Nonferrous Metals	1,588	1,501	1,467	1,564	1,772
Copper and Alloys	839	614	585	721	854
Aluminum and Alloys	473	619	615	606	668
Metal Manufactures	3,941	3,812	3,458	3,913	3,636
Finished Structural Parts and Structures	1,047	751	528	694	441
Nails and Industrial Fasteners	473	603	516	514	519
Tools	594	666	701	897	958

(continued)

Table 32: Japan's Exports by Commodity, 1983-1987 (continued)

(in millions of dollars, f.o.b. value basis)

	1983	1984	1985	1986	1987
Machinery and Transport Equipment	\$85,133	\$102,680	\$108,387	\$133,326	\$149,563
Nonelectric Machinery	23,103	27,879	29,537	38,381	44,755
Power Generating Machinery	2,992	3,835	3,789	4,940	5,904
Steam Generating Boilers and Boiler Plants	327	525	463	567	488
Internal Combustion Engines	2,240	2,800	2,885	3,842	4,876
Agricultural Machinery	1,160	1,119	1,028	1,183	1,298
Tractors	943	841	746	869	920
Office Machinery	5,139	7,554	7,785	11,305	14,392
Typewriters	432	609	555	574	366
Calculators	554	698	660	556	445
Data Processing Equipment	2,849	4,566	4,625	7,270	9,375
Metalworking Machinery	1,489	2,021	2,599	3,637	3,475
Lathes	302	423	524	676	628
Textile Machinery	759	869	1,007	1,384	1,852
Sewing Machines	457	526	524	671	861
Printing and Bookbinding Machinery	252	353	445	616	636
Construction and Mining Machinery	1,725	1,709	1,995	2,187	2,179
Excavators	619	813	965	1,062	1,191
Heating and Cooling Machinery	2,142	1,887	1,588	1,793	2,032
Pumps and Centrifuges	1,535	1,671	1,678	1,912	2,159
Air and Gas Compressors	502	642	669	740	855
Mechanical Handling Equipment	1,404	1,559	1,609	1,975	1,991
Bearings	512	658	651	806	919
Electric Machinery	22,886	29,245	29,701	35,519	40,883
Electric Power Machinery	1,873	2,137	2,058	2,453	2,724
Generators	628	630	532	490	469
Motors	416	512	495	681	808
Switchboards and Control Panels	533	691	594	810	877
Insulated Wire and Cable	781	684	701	744	693
Telecommunications Equipment	8,867	12,077	12,242	13,644	15,071
Televisions	1,472	1,905	2,625	1,727	1,422
Radios	3,440	2,820	2,654	2,756	2,464
Microphones, Loudspeakers and Amplifiers	848	963	981	1,111	1,169
Household Electric Appliances	1,412	1,817	1,968	1,874	1,713
Batteries	352	464	415	579	729
Electronic Tubes and Semiconductors	3,731	5,816	4,753	6,342	8,312
Tubes	821	984	1,002	1,339	1,795
Discrete Devices	1,762	3,248	2,419	3,185	4,212
Automotive Electrical Equipment	602	681	724	944	1,146
Electronic Measuring and Controlling Instruments	784	964	1,127	1,477	1,681
Condensers	406	534	446	654	826
Transport Equipment	39,143	45,556	49,149	59,426	63,925
Railway Equipment	411	764	525	365	624
Road Motor Vehicles	26,123	29,821	34,377	42,676	44,942
Cars	19,535	21,899	25,402	32,945	35,693
Assembled Trucks and Buses	5,175	6,372	7,396	8,022	7,324
Truck and Bus Chassis with Engines	1,371	1,475	1,517	1,633	1,815

(continued)

Table 32: Japan's Exports by Commodity, 1983-1987 (continued)

(in millions of dollars, f.o.b. value basis)

	<u>1983</u>	<u>1984</u>	<u>1985</u>	<u>1986</u>	<u>1987</u>
Road Motor Vehicle Parts	\$3,423	\$4,513	\$5,228	\$8,253	\$10,714
Motorcycles and Parts	2,667	2,598	2,626	2,686	2,628
Ships and Boats	5,996	7,353	5,929	4,879	4,360
Tankers	719	693	634	726	718
Cargo Ships	3,086	4,481	3,490	2,509	1,805
<u>Miscellaneous Manufactured Goods</u>	<u>21,198</u>	<u>24,655</u>	<u>25,752</u>	<u>31,125</u>	<u>31,599</u>
Clothing	659	776	728	734	665
Scientific, Medical and Optical Instruments	8,213	9,268	10,046	12,408	9,448
Cameras Lenses	479	449	433	542	548
Still Cameras	1,127	1,217	1,232	1,601	1,617
Measuring Instruments	497	607	676	845	945
Watches and Clocks	1,550	1,747	1,730	1,963	1,981
Stereo Equipment and Audio and					
Video Cassette Recorders and Players	7,439	9,222	9,230	11,229	10,085
Video Cassette Recorders	5,304	6,819	6,622	7,416	5,900
Phonograph Records and Tapes	1,383	1,503	1,665	2,044	1,969
Musical Instruments	555	640	688	966	1,313
Office and Stationery Supplies	324	391	412	528	582
<u>Unclassified Commodities</u>	<u>1,346</u>	<u>1,674</u>	<u>1,759</u>	<u>2,048</u>	<u>2,369</u>

Source: Ministry of Finance

Table 33: Japan's Imports by Commodity, 1983-1987

(in millions of dollars, c.i.f. value basis)

	1983	1984	1985	1986	1987
<u>Total Imports</u>	<u>\$126,393</u>	<u>\$136,503</u>	<u>\$129,539</u>	<u>\$126,408</u>	<u>\$149,515</u>
<u>Food and Live Animals</u>	<u>14,051</u>	<u>15,191</u>	<u>14,787</u>	<u>18,246</u>	<u>20,752</u>
Meat and Meat Products	1,772	1,897	1,927	2,587	3,338
Fresh and Frozen Beef	445	455	463	554	800
Fresh and Frozen Pork	645	714	703	1,041	1,417
Fish and Fish Products	3,884	4,096	4,610	6,426	7,992
Fresh and Frozen Shrimp and Lobster	1,349	1,354	1,431	1,966	2,510
Fresh and Frozen Salmon	353	345	493	571	643
Grains and Cereal Products	4,191	4,743	3,951	3,485	3,160
Wheat	1,126	1,114	974	886	785
Corn for Mixed Feed	1,572	1,669	1,363	1,158	1,101
Sorghum for Mixed Feed	386	608	536	462	326
Fruits and Vegetables	1,613	1,828	1,828	2,364	2,832
Fruits	973	1,055	1,135	1,518	1,757
Vegetables	639	733	693	846	1,075
Coffee	649	770	747	1,130	838
Animal Feeds	548	539	474	671	776
<u>Beverages and Tobacco</u>	<u>845</u>	<u>836</u>	<u>760</u>	<u>941</u>	<u>1,643</u>
Cigarettes	89	104	107	184	512
<u>Crude Materials (excl. fuels)</u>	<u>17,943</u>	<u>19,153</u>	<u>17,715</u>	<u>17,292</u>	<u>21,751</u>
Hides and Skins	412	568	504	563	585
Oilseeds and Oil Nuts	1,952	2,210	1,875	1,568	1,617
Soybeans	1,375	1,447	1,206	1,072	1,087
Rubber	597	638	544	578	661
Logs and Lumber	3,887	3,909	3,700	4,044	6,227
Logs	3,045	3,107	2,781	2,923	4,348
Lumber	842	803	919	1,106	1,879
Wood Pulp	888	1,001	910	1,124	1,441
Textile Fibers and Waste	2,077	2,484	2,155	1,863	2,702
Wool	560	675	670	621	1,017
Cotton	1,145	1,342	1,049	817	1,137
Crude Minerals	838	1,050	1,088	943	1,069
Metal Ores, Concentrates and Scrap	6,313	6,572	6,232	5,763	6,120
Iron Ore and Concentrates	3,147	3,199	3,045	2,759	2,618
Steel Scrap	451	529	407	375	322
Nonferrous Ores	2,403	2,334	2,229	2,080	2,404
Copper	1,475	1,255	1,209	1,228	1,476
Nonferrous Scrap	507	502	546	544	773
<u>Mineral Fuels</u>	<u>58,925</u>	<u>60,337</u>	<u>55,790</u>	<u>36,904</u>	<u>39,137</u>
Coal	4,877	5,311	5,197	4,927	4,634
Coking Coal	4,053	4,386	4,154	3,956	3,582
Petroleum and Products	43,705	45,486	40,575	24,117	27,445
Crude Petroleum	40,063	39,379	34,599	19,481	20,663
Petroleum Products	5,642	6,107	5,976	4,636	6,782
Residual Fuel Oil	1,807	2,130	2,020	1,093	1,477

(continued)

Table 33: Japan's Imports by Commodity, 1983-1987 (continued)

(in millions of dollars, c.i.f. value basis)

	1983	1984	1985	1986	1987
Natural and Manufactured Gas	\$8,332	\$9,529	\$10,006	\$7,843	\$7,022
Liquefied Petroleum Gas	3,285	2,935	2,806	2,092	1,970
Liquefied Methane Gas	5,046	6,594	7,200	5,751	5,052
Animal and Vegetable Oils and Fats	268	372	329	245	271
Chemicals	7,207	8,346	8,073	9,733	11,845
Chemical Elements and Compounds	3,554	4,370	4,142	4,566	5,470
Organic Chemicals	2,112	2,423	2,411	2,849	3,494
Inorganic Chemicals	526	677	742	767	869
Dyeing, Tanning and Coloring Materials	305	324	320	420	542
Pharmaceuticals	1,215	1,259	1,292	1,724	2,110
Plastic Materials	672	763	745	981	1,163
Manufactured Goods Classified Mainly by Material	10,147	11,932	10,886	12,390	18,055
Wood Manufactures	774	842	838	1,033	1,678
Wood Chips	603	645	604	679	819
Paper and Paper Products	522	545	545	747	873
Textiles (excl. fibers and apparel)	1,487	1,926	1,891	2,174	2,975
Nonmetallic Mineral Manufactures	1,101	1,201	1,264	1,927	2,847
Diamonds	526	558	567	939	1,429
Iron and Steel	1,349	1,912	1,480	1,762	2,484
Ferroalloys	411	588	524	532	581
Universals, Plates and Sheets	390	540	347	429	607
Nonferrous Metals	4,127	4,700	4,042	3,655	5,644
Precious Metals	740	848	713	825	1,414
Copper and Alloys	420	816	592	473	691
Aluminum and Alloys	2,165	2,076	1,861	1,641	2,669
Metal Manufactures	500	507	512	637	882
Machinery and Transport Equipment	9,383	10,809	11,106	13,283	17,264
Nonelectric Machinery	3,663	4,495	4,728	5,318	6,746
Power Generating Machinery	670	939	896	897	1,136
Aircraft Engines	389	458	630	666	713
Office Machinery	1,026	1,362	1,345	1,706	2,218
Computers, Peripheral Equipment and Parts	979	1,318	1,509	1,671	2,169
Electric Machinery	3,221	3,989	3,795	4,506	5,894
Electronic Tubes and Semiconductors	909	1,294	1,016	1,216	1,531
Telecommunications Equipment	427	464	438	619	975
Electronic Measuring and Controlling Instruments	566	593	643	762	918
Transport Equipment	2,499	2,325	2,583	3,459	4,624
Cars	398	457	539	1,070	2,031
Aircraft	1,472	928	1,484	1,777	1,742
Ships and Boats	390	645	286	231	269

(continued)

Table 33: Japan's Imports by Commodity, 1983-1987 (continued)

(in millions of dollars, c.i.f. value basis)

	<u>1983</u>	<u>1984</u>	<u>1985</u>	<u>1986</u>	<u>1987</u>
<u>Miscellaneous Manufactured Goods</u>	<u>\$5,204</u>	<u>\$6,088</u>	<u>\$6,349</u>	<u>\$8,634</u>	<u>\$13,396</u>
Furniture	270	307	318	431	665
Clothing	1,501	1,949	1,995	2,853	4,649
Footwear	294	380	391	490	784
Scientific, Medical and Optical Instruments	790	947	929	952	1,208
Sporting Goods	254	256	286	374	558
Art Works and Antiques	209	194	244	411	989
<u>Unclassified Commodities</u>	<u>2,418</u>	<u>3,439</u>	<u>3,744</u>	<u>8,742</u>	<u>5,402</u>
Nonmonetary Gold	1,376	2,246	2,027	6,984	3,467

Source: Ministry of Finance

Table 34: Japan's Dollar-Based Trade with the United States, 1983-1987

(in millions of dollars, customs clearance basis, seasonally unadjusted)

	Exports (f.o.b.)	Change Over Year-Earlier Period	Imports (c.i.f.)	Change Over Year-Earlier Period	Trade Balance
1983	\$42,829	17.9%	\$24,648	1.9%	\$18,181
1984	59,937	39.9	26,862	9.0	33,075
1985	65,278	8.9	25,793	-4.0	39,485
1986	80,456	23.3	29,054	12.6	51,401
1987	83,580	3.9	31,491	8.4	52,090
1986 January	4,956	20.8	2,055	-6.8	2,901
February	5,726	25.6	2,007	-9.9	3,719
March	6,013	28.3	2,215	-5.2	3,798
April	7,019	21.3	2,275	-2.2	4,744
May	6,940	21.8	2,909	27.1	4,031
June	6,962	30.0	3,121	54.0	3,841
July	7,491	28.6	2,977	39.9	4,513
August	6,496	26.6	2,086	-0.7	4,411
September	7,293	28.8	2,462	30.9	4,831
October	7,506	24.3	2,524	7.1	4,981
November	6,893	13.8	2,001	-1.4	4,892
December	7,161	12.2	2,421	28.5	4,740
1987 January	5,598	13.0	2,320	12.9	3,278
February	6,212	8.5	2,246	11.9	3,966
March	6,191	3.0	2,420	9.2	3,771
April	7,429	3.8	2,300	1.1	5,129
May	6,355	0.2	2,509	-13.7	4,445
June	6,797	-2.4	2,783	-10.8	4,014
July	7,638	2.0	2,849	-4.3	4,789
August	6,396	-1.5	2,670	28.0	3,727
September	7,593	4.1	2,733	11.0	4,860
October	7,731	3.0	2,749	8.9	4,982
November	7,018	1.8	2,809	40.4	4,209
December	8,021	12.0	3,102	28.1	4,919

Source: Ministry of Finance

Table 35: Japan's Yen-Based Trade with the United States, 1983-1987

(in billions of yen, customs clearance basis, seasonally unadjusted)

	Exports (f.o.b.)	Change Over Year-Earlier Period	Imports (c.i.f.)	Change Over Year-Earlier Period	Trade Balance
1983	¥10,179	12.9%	¥5,855	-2.3%	¥4,323
1984	14,221	39.7	6,364	8.7	7,858
1985	15,583	9.6	6,213	-2.4	9,369
1986	13,564	-13.0	4,918	-20.9	8,646
1987	12,148	-10.4	4,582	-6.8	7,566
1986 January	1,001	-3.4	415	-25.3	586
February	1,107	-3.5	389	-32.1	718
March	1,083	-11.3	399	-34.4	684
April	1,254	-14.7	406	-31.3	848
May	1,157	-19.2	486	-15.5	671
June	1,177	-12.1	528	4.1	649
July	1,220	-14.8	486	-7.3	734
August	1,007	-17.5	323	-35.3	684
September	1,128	-16.8	381	-15.4	748
October	1,158	-13.7	389	-25.4	768
November	1,105	-12.8	321	-24.5	785
December	1,166	-9.9	394	3.3	772
1987 January	887	-11.4	369	-11.1	518
February	949	-14.2	343	-11.7	606
March	950	-12.3	371	-7.0	579
April	1,091	-13.0	338	-16.8	753
May	974	-13.9	351	-27.8	623
June	970	-17.6	397	-24.9	573
July	1,130	-7.4	421	-13.3	709
August	965	-4.2	403	24.5	562
September	1,085	-3.8	391	2.7	694
October	1,117	-3.5	398	2.1	720
November	971	-12.2	389	21.3	581
December	1,061	-9.0	411	4.4	649

Source: Ministry of Finance

Table 36: Yen-Dollar Exchange Rate Used to Convert
Customs Clearance Trade Data, 1983-1987*

	Exports	Imports
1983 Average	Y237.52	Y237.59
1984 Average	236.95	236.91
1985 Average	240.29	240.17
1986 Average	169.99	170.08
1987 Average	145.90	146.01
1986 January	202.02	202.07
February	193.28	193.53
March	180.12	180.21
April	178.70	178.62
May	166.77	167.08
June	169.07	169.29
July	162.84	163.17
August	155.03	155.04
September	154.72	154.66
October	154.23	154.23
November	160.37	160.34
December	162.77	162.73
1987 January	158.43	159.01
February	152.83	152.70
March	153.43	153.47
April	146.83	146.97
May	139.98	139.91
June	142.67	142.58
July	147.89	147.81
August	150.83	150.83
September	142.94	143.02
October	144.50	144.59
November	138.28	138.52
December	132.21	132.65

*Reflects the exchange rate that prevailed at
the time export or import contracts were signed.

Source: Ministry of Finance

Table 37: Yen-Dollar Exchange Rate on Tokyo
Foreign Exchange Market, 1983-1987

	(average for period)				
	1983	1984	1985	1986	1987
Average	Y237.51	Y237.52	Y238.54	Y168.52	Y144.64
January	232.94	233.94	254.18	200.07	154.48
February	236.24	233.68	260.24	184.64	153.48
March	238.03	225.40	258.63	178.93	151.54
April	237.71	224.95	251.67	175.62	142.98
May	234.74	230.66	251.54	166.83	140.54
June	240.15	233.21	248.99	167.95	144.48
July	240.50	242.84	241.75	158.60	150.21
August	244.33	242.30	237.21	154.00	147.56
September	242.77	245.23	236.95	154.72	143.00
October	233.01	246.79	214.73	155.95	143.54
November	235.31	243.32	203.72	162.64	135.25
December	234.41	247.95	202.82	162.29	128.59

Source: International Monetary Fund

Table 38: Japan's Foreign Direct Investment by Country,
FY 1983-FY 1987

(in millions of dollars)

	FY 1983	FY 1984	FY 1985	FY 1986	FY 1987	Total March 31, 1988
United States	\$2,565	\$3,360	\$5,395	\$10,165	\$14,704	\$50,159
Canada	136	184	100	276	653	2,604
North America	2,701	3,544	5,495	10,441	15,357	52,763
Indonesia	374	374	408	250	545	9,218
Hong Kong	563	412	131	502	1,072	4,505
Singapore	322	225	339	302	494	3,065
Korea	129	107	134	436	647	2,765
China	---	114	100	226	1,226	1,740
Malaysia	140	142	79	158	163	1,446
Taiwan	103	65	114	291	367	1,419
Thailand	72	119	48	124	250	1,134
Philippines	65	46	61	21	72	985
Asia	1,847	1,628	1,435	2,327	4,868	26,658
Panama	1,223	1,671	1,533	2,401	2,305	11,146
Brazil	410	318	314	270	229	5,086
Caymans	1	1	132	930	1,197	2,476
Bahamas	1	97	298	792	734	1,981
Mexico	121	56	101	226	28	1,584
Peru	---	6	10	---	1	696
Bermuda	14	29	148	16	36	653
Netherlands Antilles	69	66	62	66	199	575
Latin America	1,878	2,290	2,616	4,737	4,816	25,189
United Kingdom	153	318	375	984	2,473	6,598
Luxembourg	265	315	300	1,092	1,764	4,072
Netherlands	113	452	613	651	829	3,166
West Germany	117	245	172	210	403	1,955
France	93	117	67	152	330	1,300
Switzerland	37	229	60	91	224	977
Spain	52	140	91	86	283	883
Belgium	126	71	84	50	70	863
Europe	990	1,937	1,930	3,469	6,576	21,047
Australia	166	105	468	881	1,222	5,724
Oceania	191	157	525	992	1,413	6,647
Liberia	323	281	159	289	267	3,010
Africa	364	326	172	309	272	3,951
Kuwait	66	55	34	41	54	1,363
Iran	1	0	0	---	---	1,003
Middle East	175	273	45	44	62	3,079
Total	8,145	10,155	12,217	22,320	33,364	139,334

Source: Ministry of Finance

Table 39: Japan's Foreign Direct Investment by Industry,
FY 1983-FY 1987

(in millions of dollars)

	FY 1983	FY 1984	FY 1985	FY 1986	FY 1987	Total March 31, 1988
Manufacturing Sector	\$2,588	\$2,505	\$2,352	\$3,806	\$7,832	\$36,038
Food Products	77	118	90	127	328	1,546
Textiles	174	85	28	63	206	2,353
Wood and Paper Products	91	115	15	57	317	1,495
Chemicals	450	223	133	355	910	5,247
Metals	479	718	385	328	786	6,304
Nonelectric Machinery	169	185	352	626	687	3,284
Electric Machinery	502	409	513	987	2,421	7,155
Transport Equipment	486	437	627	828	1,473	5,675
Other	160	215	208	435	703	2,980
Nonmanufacturing Sector	5,357	7,429	9,536	17,949	25,080	99,365
Agriculture/Forestry	18	26	12	15	97	893
Fisheries	17	24	42	52	44	538
Mining	382	484	598	669	511	12,936
Construction	55	112	94	250	87	1,134
Trade/Sales	1,164	1,482	1,550	1,861	2,269	16,807
Banking/Finance/Insurance	1,167	2,085	3,805	7,240	10,673	28,772
Services	622	681	665	1,560	2,780	9,026
Transportation	1,363	1,651	1,240	1,925	2,145	9,970
Real Estate	375	430	1,207	3,997	5,428	11,958
Other	193	454	322	379	1,047	7,332
Branch Offices	200	221	329	566	452	3,336
Real Estate Transactions*	---	---	---	---	---	595
Total	8,145	10,155	12,217	22,320	33,364	139,334

*Overseas real estate transactions have been excluded from Japan's foreign direct investment data since December 1, 1980 because of changes in the Foreign Exchange and Foreign Trade Control Law.

Source: Ministry of Finance

Table 40: U.S. International Transactions, 1983-1987

(in millions of dollars, IMF value basis)

	1983	1984	1985	1986	1987
Merchandise Trade Balance	\$-67,080	\$-112,522	\$-122,148	\$-144,547	\$-160,280
Exports	201,820	219,900	215,935	223,969	249,570
Imports	268,900	332,422	338,083	368,516	409,850
Services Balance	30,313	17,546	22,056	21,026	19,761
Military	-243	-2,099	-3,431	-4,372	-2,368
Travel	-4,595	-7,570	-9,080	-8,087	-9,105
Other Transportation	368	-1,034	-969	-1,257	-1,176
Investment Income	24,875	18,489	25,936	23,142	20,375
Direct	14,901	11,988	27,123	33,038	41,804
Other	9,974	6,501	-1,187	-9,896	-21,429
Fees and Royalties	4,553	4,674	5,103	6,273	7,702
Other Services	5,355	5,086	4,497	5,327	4,333
Unilateral Transfers Balance	-9,480	-12,102	-15,010	-15,308	-13,445
Current Account Balance	-46,248	-107,077	-115,103	-138,828	-153,964
Private Capital Flows (net)	35,447	85,796	105,146	89,443	80,225
Direct Investments (net)	11,573	22,538	954	6,280	-2,478
Securities (net)	10,091	30,813	63,914	70,481	30,161
Banking Flows (net)	20,414	22,722	39,722	19,808	47,247
Other Flows (net)	-6,631	9,723	557	-7,126	5,295
U.S. Government Assets (other than official reserves) (net)	-5,006	-5,489	-2,829	-2,000	1,162
U.S. Official Reserve Assets (net)	-1,196	-3,131	-3,858	312	9,149
Foreign Official Assets (net)	5,845	3,140	-1,196	35,507	44,968
Statistical Discrepancy	11,154	26,760	17,839	15,566	18,461

Note: For capital transactions, credits (+) indicate net inflows and debits (-) indicate net outflows.

Source: Department of Commerce

Table 41: U.S. Current Account Balance with Japan, 1983-1987

(in millions of dollars, IMF value basis)

	<u>1983</u>	<u>1984</u>	<u>1985</u>	<u>1986</u>	<u>1987</u>
Merchandise Trade Balance	\$-21,055	\$-36,969	\$-43,508	\$-54,422	\$-56,944
Exports	21,789	23,241	22,145	26,344	27,604
Imports	42,844	60,210	65,653	80,766	84,548
Services Balance	1,339	-756	-1,631	-1,618	-1,530
Military	-917	-1,035	-1,264	-1,827	-1,644
Travel	1,307	1,396	1,465	1,428	1,966
Other Transportation	-177	-471	-580	-727	-807
Investment Income	39	-1,613	-2,381	-1,584	-2,345
Direct	92	-1,154	56	2,336	2,464
Other	-53	-459	-2,437	-3,920	-4,809
Fees and Royalties	809	835	936	1,129	1,499
Other Services	278	132	193	-37	-199
Unilateral Transfers Balance	-49	-67	-68	-68	-68
Current Account Balance	-19,765	-37,792	-45,208	-56,109	-58,544

Source: Department of Commerce

Table 42: U.S. Exports and Imports, 1983-1987

(in millions of dollars, seasonally unadjusted)

		Exports* (f.a.s.)	Change Over Year-Earlier Period	Imports (Customs)	Change Over Year-Earlier Period	Trade Balance	Imports (c.i.f.)	Change Over Year-Earlier Period	Trade Balance
1983		\$200,538	-5.5%	\$258,048	5.8%	\$-57,510	\$269,878	5.9%	\$-69,341
1984		217,888	8.7	325,726	26.2	-107,838	341,177	26.4	-123,289
1985		213,146	-2.2	345,275	6.0	-132,129	361,626	6.0	-148,480
1986		217,304	2.0	369,961	7.1	-152,657	387,082	7.0	-169,777
1987		252,866	16.4	405,901	9.7	-153,035	424,082	9.6	-171,217
1986	January	17,006	-8.9	32,005	11.0	-14,999	33,465	10.6	-16,459
	February	17,735	3.4	28,895	11.4	-11,161	30,225	11.2	-12,491
	March	18,913	-7.0	31,972	11.3	-13,059	33,435	11.1	-14,522
	April	17,965	-0.0	28,762	0.7	-10,797	30,036	0.4	-12,071
	May	17,431	-4.9	30,272	3.3	-12,842	31,638	3.0	-14,208
	June	19,070	5.9	31,764	5.4	-12,694	33,240	5.2	-14,170
	July	17,707	5.9	34,121	26.4	-16,414	35,745	26.3	-18,037
	August	17,604	6.2	29,476	12.3	-11,871	30,925	12.4	-13,321
	September	17,518	2.8	28,695	-8.5	-11,177	30,078	-8.5	-12,560
	October	19,330	9.7	30,018	5.6	-10,688	31,389	5.7	-12,059
	November	18,595	4.9	36,187	20.6	-17,592	37,816	20.5	-19,221
	December	18,431	8.5	27,795	-9.5	-9,364	29,089	-9.5	-10,658
1987	January	16,755	-1.5	27,466	-14.2	-10,711	28,692	-14.3	-11,937
	February	19,360	9.2	32,307	11.8	-12,946	33,725	11.6	-14,365
	March	21,776	15.1	33,197	3.8	-11,421	34,694	3.8	-12,918
	April	20,496	14.1	31,983	11.2	-11,487	33,459	11.4	-12,963
	May	20,784	19.2	33,313	10.0	-12,529	34,822	10.1	-14,039
	June	21,126	10.8	35,266	11.0	-14,140	36,838	10.8	-15,711
	July	21,008	18.6	35,844	5.1	-14,836	37,483	4.9	-16,475
	August	20,222	14.9	34,320	16.4	-14,098	35,905	16.1	-15,683
	September	20,986	19.8	33,573	17.0	-12,587	35,062	16.6	-14,076
	October	21,752	12.5	37,714	25.6	-15,962	39,383	25.5	-17,631
	November	23,799	28.0	35,474	-2.0	-11,676	37,016	-2.1	-13,218
	December	24,801	34.6	35,444	27.5	-10,642	37,003	27.2	-12,202

*Domestic and foreign merchandise, including Department of Defense shipments. Annual and monthly data for 1987 reflect undocumented exports to Canada.

Source: Department of Commerce

Table 43: U.S. Exports by Major Market, 1983-1987

(in millions of dollars, f.a.s. value basis)

	1983	1984	1985	1986	1987
<u>Total</u>	<u>\$200,538</u>	<u>\$217,888</u>	<u>\$213,146</u>	<u>\$217,304</u>	<u>\$252,866</u>
<u>Western Hemisphere</u>					
Canada	63,970	76,209	78,271	76,411	94,795
Mexico	38,244	46,524	47,251	45,333	59,814
Brazil	9,082	11,992	13,635	12,392	14,582
Venezuela	2,557	2,640	3,140	3,885	4,040
Colombia	2,811	3,377	3,399	3,141	3,586
	1,514	1,450	1,468	1,319	1,412
<u>Western Europe</u>					
United Kingdom	55,980	58,019	56,763	61,642	69,718
West Germany	10,621	12,210	11,273	11,418	14,114
Netherlands	8,737	9,084	9,050	10,561	11,748
France	7,767	7,554	7,269	7,848	8,217
Belgium-Luxembourg	5,961	6,037	6,096	7,216	7,943
Italy	5,049	5,301	4,918	5,399	6,189
European Community*	3,908	4,375	4,625	4,838	5,530
Switzerland	44,311	46,976	45,776	53,154	60,575
Spain	2,960	2,563	2,288	2,977	3,151
Sweden	2,763	2,561	2,524	2,615	3,148
	1,581	1,542	1,925	1,871	1,894
<u>Asia and Middle East</u>					
Japan	61,620	61,506	56,869	61,396	69,746
Korea	21,894	23,575	22,631	26,882	28,249
Taiwan	5,925	5,983	5,956	6,355	8,099
Singapore	4,667	5,003	4,700	5,524	7,413
Hong Kong	3,759	3,675	3,476	3,380	4,053
Saudi Arabia	2,564	3,062	2,786	3,030	3,983
Israel	7,903	5,564	4,474	3,449	3,373
Malaysia	2,017	2,194	2,580	2,239	3,130
Philippines	1,684	1,856	1,539	1,730	1,897
Thailand	1,807	1,766	1,379	1,363	1,599
India	1,063	1,113	849	936	1,544
Indonesia	1,828	1,570	1,642	1,536	1,463
	1,466	1,216	795	946	767
<u>Australia and Oceania</u>					
Australia	4,827	5,745	6,399	6,659	6,526
	3,954	4,793	5,441	5,551	5,495
<u>Africa</u>					
Egypt	8,768	8,827	7,388	5,978	6,283
South Africa	2,813	2,704	2,323	1,982	2,210
Nigeria	2,129	2,265	1,205	1,158	1,281
	864	577	676	409	295
<u>Communist Countries</u>					
China	5,085	7,214	7,091	5,125	5,721
Soviet Union	2,173	3,004	3,856	3,106	3,497
	2,003	3,284	2,423	1,248	1,480

*1986 and 1987 figures include Spain and Portugal.

Source: Department of Commerce

Table 44: U.S. Imports by Major Supplier, 1983-1987

(in millions of dollars, c.i.f. value basis)

	1983	1984	1985	1986	1987
<u>Total</u>	<u>\$269,878</u>	<u>\$341,177</u>	<u>\$361,626</u>	<u>\$387,082</u>	<u>\$424,082</u>
<u>Western Hemisphere</u>	<u>96,127</u>	<u>116,974</u>	<u>118,523</u>	<u>112,774</u>	<u>120,605</u>
Canada	52,546	66,911	69,427	68,662	71,510
Mexico	17,019	18,267	19,392	17,558	20,520
Brazil	5,382	8,273	8,147	7,340	8,433
Venezuela	5,173	6,820	6,830	5,446	5,881
Colombia	1,058	1,253	1,456	2,039	2,414
<u>Western Europe</u>	<u>56,437</u>	<u>74,921</u>	<u>84,209</u>	<u>94,297</u>	<u>99,934</u>
United Kingdom	12,900	15,044	15,573	16,033	17,998
West Germany	13,229	17,810	21,232	26,128	28,028
Netherlands	3,149	4,330	4,368	4,363	4,236
France	6,308	8,516	9,960	10,586	11,177
Belgium-Luxembourg	2,510	3,287	3,567	4,191	4,359
Italy	5,819	8,504	10,381	11,312	11,698
European Community*	45,879	60,267	68,246	79,520	84,876
Switzerland	2,552	3,199	3,579	5,367	4,363
Spain	1,685	2,627	2,774	2,956	3,101
Sweden	2,549	3,427	4,339	4,637	4,981
<u>Asia and Middle East</u>	<u>94,802</u>	<u>124,664</u>	<u>135,840</u>	<u>157,426</u>	<u>177,283</u>
Japan	43,559	60,371	72,380	85,457	88,074
Korea	7,657	10,027	10,713	13,497	17,991
Taiwan	12,110	16,088	17,761	21,252	26,407
Singapore	2,969	4,121	4,412	4,884	6,395
Hong Kong	6,825	8,899	8,994	9,474	10,490
Saudi Arabia	3,840	4,009	2,027	4,054	4,887
Israel	1,300	1,809	2,201	2,505	2,724
Malaysia	2,205	2,825	2,399	2,534	3,053
Philippines	2,159	2,622	2,334	2,150	2,481
Thailand	1,035	1,426	1,543	1,873	2,387
India	2,334	2,737	2,478	2,465	2,725
Indonesia	5,657	5,868	4,933	3,675	3,719
<u>Australia and Oceania</u>	<u>3,354</u>	<u>3,885</u>	<u>4,170</u>	<u>4,080</u>	<u>4,550</u>
Australia	2,422	2,899	3,069	2,873	3,287
<u>Africa</u>	<u>15,206</u>	<u>14,996</u>	<u>12,543</u>	<u>11,057</u>	<u>12,680</u>
Egypt	325	182	84	123	498
South Africa	2,099	2,577	2,180	2,476	1,399
Nigeria	3,883	2,606	3,108	2,681	3,767
<u>Communist Countries</u>	<u>3,952</u>	<u>5,736</u>	<u>6,342</u>	<u>7,447</u>	<u>9,030</u>
China	2,477	3,381	4,224	5,241	6,911
Soviet Union	374	600	443	606	470

*1986 and 1987 figures include Spain and Portugal.

Source: Department of Commerce

Table 45: U.S. Trade Balance with Major Trading Partners, 1983-1987

(in millions of dollars; exports f.a.s., imports c.i.f.)

	1983	1984	1985	1986	1987
<u>Total</u>	<u>\$-69,341</u>	<u>\$-123,289</u>	<u>\$-148,480</u>	<u>\$-169,777</u>	<u>\$-171,217</u>
<u>Western Hemisphere</u>	<u>-32,157</u>	<u>-40,766</u>	<u>-40,252</u>	<u>-36,364</u>	<u>-25,810</u>
Canada	-14,302	-20,387	-22,176	-23,330	-11,696
Mexico	-7,937	-6,275	-5,757	-5,167	-5,938
Brazil	-2,825	-5,633	-5,007	-3,455	-4,393
Venezuela	-2,362	-3,443	-3,431	-2,305	-2,295
Colombia	456	197	12	-720	-1,003
<u>Western Europe</u>	<u>-457</u>	<u>-16,902</u>	<u>-27,446</u>	<u>-32,655</u>	<u>-30,216</u>
United Kingdom	-2,279	-2,834	-4,300	-4,614	-3,884
West Germany	-4,492	-8,726	-12,182	-15,568	-16,281
Netherlands	4,618	3,224	2,901	3,485	3,981
France	-147	-2,479	-3,864	-3,370	-3,233
Belgium-Luxembourg	2,539	2,014	1,351	1,208	1,830
Italy	-1,911	-4,129	-5,756	-6,473	-6,168
European Community*	-1,568	-13,291	-22,470	-26,366	-24,301
Switzerland	408	-636	-1,291	-2,391	-1,212
Spain	1,078	-66	-250	-341	47
Sweden	-968	-1,885	-2,414	-2,766	-3,088
<u>Asia and Middle East</u>	<u>-33,182</u>	<u>-63,158</u>	<u>-78,971</u>	<u>-96,031</u>	<u>-107,538</u>
Japan	-21,665	-36,796	-49,749	-58,575	-59,825
Korea	-1,732	-4,044	-4,757	-7,142	-9,892
Taiwan	-7,443	-11,085	-13,061	-15,727	-18,994
Singapore	790	-446	-936	-1,504	-2,342
Hong Kong	-4,261	-5,837	-6,208	-6,444	-6,507
Saudi Arabia	4,063	1,555	2,447	-606	-1,513
Israel	717	385	379	-267	406
Malaysia	-521	-969	-860	-805	-1,157
Philippines	-352	-856	-955	-787	-882
Thailand	28	-313	-694	-937	-833
India	-506	-1,167	-836	-928	-1,262
Indonesia	-4,191	-4,652	-4,138	-2,730	-2,952
<u>Australia and Oceania</u>	<u>1,473</u>	<u>1,860</u>	<u>2,229</u>	<u>2,578</u>	<u>1,976</u>
Australia	1,532	1,894	2,372	2,679	2,208
<u>Africa</u>	<u>-6,438</u>	<u>-6,169</u>	<u>-5,155</u>	<u>-5,079</u>	<u>-6,396</u>
Egypt	2,488	2,522	2,239	1,859	1,712
South Africa	30	-312	-975	-1,318	-118
Nigeria	-3,019	-2,029	-2,432	-2,272	-3,472
<u>Communist Countries</u>	<u>1,132</u>	<u>1,479</u>	<u>749</u>	<u>-2,322</u>	<u>-3,309</u>
China	-304	-377	-368	-2,134	-3,413
Soviet Union	1,629	2,684	1,980	642	1,010

*1986 and 1987 figures include Spain and Portugal.

Source: Department of Commerce

Table 46: U.S. Exports by Commodity, 1983-1987

(in millions of dollars, f.a.s. value basis)

	1983	1984	1985	1986	1987
<u>Total Exports*</u>	<u>\$195,969</u>	<u>\$212,057</u>	<u>\$206,925</u>	<u>\$206,376</u>	<u>\$243,859</u>
<u>Agricultural Commodities</u>	<u>36,108</u>	<u>37,813</u>	<u>29,242</u>	<u>26,061</u>	<u>28,636</u>
<u>Nonagricultural Commodities</u>	<u>159,862</u>	<u>174,245</u>	<u>177,684</u>	<u>180,315</u>	<u>215,223</u>
<u>Food and Live Animals</u>	<u>24,166</u>	<u>24,463</u>	<u>19,268</u>	<u>17,303</u>	<u>19,179</u>
Meat and Meat Products	1,191	1,208	1,153	1,424	1,768
Fish and Fish Products	917	850	1,016	1,297	1,588
Grain and Cereal Products	15,152	16,076	11,050	7,368	8,058
Wheat	6,235	6,477	3,601	3,010	3,045
Corn	6,480	7,081	5,319	2,718	3,314
Sorghum	731	880	839	389	406
Rice	926	845	665	621	576
Vegetables and Fruits	2,444	2,435	2,377	2,657	2,956
Animal Feeds	2,802	2,226	1,891	2,622	2,692
<u>Beverages and Tobacco</u>	<u>2,813</u>	<u>2,849</u>	<u>2,958</u>	<u>2,920</u>	<u>3,667</u>
Unmanufactured Tobacco	1,462	1,511	1,521	1,210	1,091
Cigarettes	1,126	1,120	1,180	1,298	2,047
<u>Inedible Crude Materials</u>	<u>18,596</u>	<u>20,249</u>	<u>16,940</u>	<u>17,324</u>	<u>20,416</u>
Hides and Skins	807	1,171	1,088	1,314	1,450
Soybeans	5,925	5,438	3,906	4,334	4,343
Rubber	543	624	584	649	761
Logs and Lumber	2,104	2,042	2,037	2,240	3,008
Paper Base Stocks	1,916	2,144	1,946	2,318	3,084
Raw Cotton	1,817	2,441	1,633	773	1,631
Steel Scrap	637	918	917	1,054	967
Nonferrous Ores and Scrap	1,456	1,508	1,534	1,543	1,853
<u>Mineral Fuels</u>	<u>9,500</u>	<u>9,311</u>	<u>9,971</u>	<u>8,115</u>	<u>7,713</u>
Bituminous Coal	4,008	4,090	4,398	3,862	3,310
Petroleum and Products	4,557	4,470	4,707	3,640	3,922
<u>Animal and Vegetable Oils and Fats</u>	<u>1,459</u>	<u>1,922</u>	<u>1,434</u>	<u>1,015</u>	<u>981</u>
<u>Chemicals</u>	<u>19,751</u>	<u>22,336</u>	<u>21,759</u>	<u>22,766</u>	<u>26,381</u>
Chemical Elements and Compounds	8,378	9,699	9,290	9,367	10,679
Organic Chemicals	5,326	6,093	6,012	6,293	7,550
Inorganic Chemicals	3,051	3,605	3,278	3,073	3,129
Pharmaceuticals	2,494	2,628	2,708	3,090	3,182
Fertilizers	1,267	1,815	2,160	1,935	2,259
Plastic Materials	3,732	4,050	3,777	4,301	5,493
<u>Manufactured Goods Classified</u>					
<u>Chiefly by Material</u>	<u>14,852</u>	<u>15,140</u>	<u>14,009</u>	<u>14,005</u>	<u>17,136</u>
Paper and Paper Products	2,553	2,620	2,329	2,602	3,180
Textiles (excl. clothing)	2,368	2,382	2,366	2,570	2,933
Nonmetallic Mineral Products	1,770	1,865	1,821	1,886	2,289
Steel Mill Products	1,415	1,248	1,152	1,020	1,223

(continued)

Table 46: U.S. Exports by Commodity, 1983-1987 (continued)

(in millions of dollars, f.a.s. value basis)

	1983	1984	1985	1986	1987
Nonferrous Metals and Alloys	\$1,606	\$1,634	\$1,472	\$1,195	\$1,699
Aluminum and Alloys	1,010	990	937	816	1,202
Metal Manufactures	3,444	3,602	3,253	3,008	3,534
<u>Machinery and Transport Equipment</u>	<u>82,578</u>	<u>89,973</u>	<u>94,278</u>	<u>95,290</u>	<u>108,596</u>
Machinery	54,309	60,318	59,488	60,397	69,637
Power Generating Machinery	8,718	9,114	9,272	9,165	10,193
Aircraft Engines and Parts	2,788	3,011	3,316	3,694	4,420
Automotive Engines and Parts	2,082	2,410	2,494	2,269	2,335
Agricultural Machinery and Parts	1,589	1,740	1,601	1,421	1,493
Construction Equipment and Parts	766	761	820	714	773
Mining and Drilling Machinery and Parts	2,911	2,637	2,922	2,355	1,705
Textile and Sewing Machinery	453	520	498	554	661
Printing and Bookbinding Machinery and Parts	478	465	439	487	628
Metalworking Machinery	1,121	1,175	1,249	1,467	1,606
Heating and Cooling Machinery and Parts	1,854	1,888	1,791	1,740	2,000
Pumps and Parts	948	962	933	849	928
Centrifuges and Filtering and Purifying Machinery and Parts	734	628	537	515	639
Computers, Peripherals and Parts	10,453	13,352	13,841	14,514	17,495
Telecommunications Equipment	3,804	3,943	4,167	4,408	5,085
Other Electric Machinery and Parts	11,936	13,855	12,489	13,630	16,637
Electric Power Apparatus	2,379	2,790	2,616	2,800	3,243
Household Appliances	611	626	551	542	742
Transport Equipment	28,269	29,655	34,790	34,893	38,959
Cars	4,200	4,868	6,020	6,254	6,689
Trucks and Buses	1,411	1,686	2,183	2,257	2,704
Automotive Parts (excl. engines, tires and electrical parts)	3,254	3,994	9,376	8,492	9,657
Tractor Parts	972	1,146	1,085	866	960
Commercial Aircraft	5,691	4,147	6,694	7,366	7,517
Military Aircraft	1,845	1,581	2,012	1,502	2,628
Aircraft Parts	4,526	5,061	5,580	6,111	6,645
Rail Locomotives and Rolling Stock	402	584	427	538	346
Ships, Boats and Floating Structures	811	221	306	330	361
<u>Miscellaneous Manufactured Goods</u>	<u>15,246</u>	<u>15,699</u>	<u>15,338</u>	<u>16,629</u>	<u>19,409</u>
Furniture	593	622	560	534	624
Clothing	818	807	754	899	1,156
Professional, Scientific and Medical Equipment and Measuring and Controlling Instruments	5,856	6,198	6,505	6,732	7,388
Photographic Supplies	1,366	1,464	1,313	1,418	1,472
Printed Material	1,324	1,391	1,279	1,342	1,562
Toys and Sporting Goods	878	674	579	628	885
Musical Instruments and Parts	860	927	898	1,112	1,487
<u>Unclassified Commodities</u>	<u>7,009</u>	<u>10,116</u>	<u>10,971</u>	<u>11,011</u>	<u>20,381</u>

*Domestic merchandise only, including Department of Defense shipments.

Source: Department of Commerce

Table 47: U.S. Imports by Commodity, 1983-1987

(in millions of dollars, c.i.f. value basis)

	1983	1984	1985	1986	1987
<u>Total Imports</u>	<u>\$269,878</u>	<u>\$341,177</u>	<u>\$361,626</u>	<u>\$387,082</u>	<u>\$424,082</u>
<u>Agricultural Commodities</u>	<u>18,104</u>	<u>21,522</u>	<u>22,020</u>	<u>23,176</u>	<u>22,624</u>
<u>Nonagricultural Commodities</u>	<u>251,775</u>	<u>319,605</u>	<u>339,607</u>	<u>363,906</u>	<u>401,458</u>
<u>Food and Live Animals</u>	<u>16,692</u>	<u>19,428</u>	<u>20,292</u>	<u>22,395</u>	<u>22,224</u>
Meat and Meat Products	2,241	2,232	2,472	2,601	3,038
Fish and Fish Products	3,764	3,859	4,202	4,933	5,872
Grains and Animal Feeds	515	662	767	803	880
Vegetables and Fruits	3,382	4,447	4,619	4,825	5,133
Sugar	1,113	1,333	1,002	717	481
Coffee	2,731	3,215	3,284	4,432	2,846
<u>Beverages and Tobacco</u>	<u>3,710</u>	<u>4,007</u>	<u>4,124</u>	<u>4,226</u>	<u>4,461</u>
Alcoholic Beverages	2,876	3,147	3,298	3,362	3,554
Unmanufactured Tobacco	491	666	571	626	624
<u>Inedible Crude Materials</u>	<u>10,272</u>	<u>11,882</u>	<u>11,167</u>	<u>11,176</u>	<u>12,299</u>
Crude Rubber	731	915	746	691	837
Lumber	2,816	2,952	3,195	3,268	3,464
Paper Base Stocks	1,525	1,907	1,572	1,659	2,132
Iron Ore and Concentrates	531	628	561	549	478
Nonferrous Ores and Concentrates	1,449	1,775	1,418	1,140	1,303
Bauxite	1,116	1,350	1,071	875	941
<u>Mineral Fuels</u>	<u>60,215</u>	<u>63,297</u>	<u>55,843</u>	<u>39,838</u>	<u>46,724</u>
Petroleum and Products	54,358	58,167	51,471	36,550	43,936
Crude Petroleum	38,184	37,945	34,124	24,181	30,840
Petroleum Products	16,174	20,222	17,348	12,369	13,096
Fuel Oil	9,410	10,907	8,100	5,879	6,442
Natural and Manufactured Gas	5,748	4,964	4,176	3,092	2,381
<u>Animal and Vegetable Oils and Fats</u>	<u>541</u>	<u>742</u>	<u>730</u>	<u>581</u>	<u>630</u>
<u>Chemicals</u>	<u>11,305</u>	<u>14,401</u>	<u>15,321</u>	<u>15,804</u>	<u>17,037</u>
Chemical Elements and Compounds	6,324	8,093	8,386	8,393	8,884
Organic Chemicals	3,646	4,489	4,833	4,968	5,686
Inorganic Chemicals	2,678	3,603	3,554	3,425	3,199
Pharmaceuticals	719	951	1,108	1,267	1,484
Fertilizers	1,056	1,221	1,049	953	868
<u>Manufactured Goods Classified</u>					
<u>Chiefly by Material</u>	<u>36,750</u>	<u>49,018</u>	<u>49,499</u>	<u>51,700</u>	<u>56,364</u>
Tires and Tubes	1,503	1,983	2,086	2,129	2,443
Plywood and Veneers	826	879	905	994	1,197
Paper and Paper Products	4,362	5,822	6,248	6,630	7,613
Newsprint	2,817	3,370	3,720	3,760	4,209
Textiles (excl. clothing)	3,460	4,874	5,274	6,151	6,927
Yarn and Thread	378	558	574	736	782
Cotton Fabrics	594	935	892	1,064	1,363

(continued)

Table 47: U.S. Imports by Commodity, 1983-1987 (continued)

(in millions of dollars, c.i.f. value basis)

	1983	1984	1985	1986	1987
Glass, Glassware and Tableware	\$1,744	\$2,176	\$2,406	\$2,699	\$3,094
Gem Diamonds	2,283	2,917	3,020	3,476	3,442
Steel Mill Products	6,919	11,146	10,614	8,900	9,178
Wire Rods and Bars	1,433	2,053	1,963	1,758	1,885
Plates and Sheets	3,265	4,958	4,615	4,170	4,375
Tubes, Pipes and Fittings	1,497	2,882	2,671	1,732	1,620
Nonferrous Metals and Alloys	7,545	8,350	7,172	7,881	8,154
Precious Metals	2,642	1,916	1,834	1,951	1,618
Copper and Alloys	1,382	1,570	1,195	1,428	1,597
Nickel and Alloys	533	608	614	522	581
Aluminum and Alloys	1,668	2,522	2,066	2,833	2,928
Metal Manufactures	4,807	6,347	7,022	7,575	8,512
<u>Machinery and Transport Equipment</u>	<u>88,928</u>	<u>123,104</u>	<u>141,721</u>	<u>166,240</u>	<u>182,807</u>
Machinery	48,409	70,657	77,717	90,101	102,262
Power Generating Machinery	5,384	7,465	9,051	9,997	11,068
Agricultural Machinery and Tractors	1,237	1,577	1,499	1,648	1,900
Textile and Sewing Machinery	1,098	1,336	1,155	1,502	1,875
Metalworking Machinery	1,540	2,116	2,886	3,385	3,090
Office Machinery and Computers	6,979	11,175	11,917	15,114	19,027
Telecommunications Equipment	11,619	16,423	19,114	21,157	21,272
Radio Sets	864	1,056	1,025	870	936
Television Sets	1,788	2,246	2,327	2,762	2,525
Stereo Equipment and Audio and Video Cassette Recorders	2,756	4,369	6,038	6,827	5,557
Other Electric Machinery and Parts	12,828	18,789	18,192	20,718	25,091
Transport Equipment	40,519	52,447	64,003	76,140	80,546
Road Motor Vehicles	29,817	37,830	47,009	56,275	58,604
Cars	23,757	30,147	37,617	46,555	49,134
Automotive Parts (excl. engines, tires and electrical parts)	6,441	9,059	10,568	12,245	14,143
Motorcycles and Parts	838	772	1,014	961	655
Aircraft and Parts	2,073	3,033	3,600	4,525	4,512
<u>Miscellaneous Manufactured Goods</u>	<u>33,637</u>	<u>45,361</u>	<u>51,684</u>	<u>60,079</u>	<u>69,037</u>
Clothing	10,292	14,513	16,056	18,554	21,960
Footwear	4,291	5,424	6,104	6,857	7,654
Professional, Scientific and Controlling Instruments	1,963	2,770	3,298	3,987	4,621
Clocks and Watches	1,089	1,294	1,406	1,576	1,744
Printed Matter	778	1,041	1,175	1,446	1,569
Toys and Sporting Goods	2,702	3,700	4,451	5,088	6,438
Art Works and Antiques	2,033	2,489	2,217	2,123	1,978
<u>Unclassified Commodities</u>	<u>7,830</u>	<u>9,938</u>	<u>11,245</u>	<u>15,042</u>	<u>12,500</u>

Source: Department of Commerce

Table 48: U.S. Trade with Japan, 1983-1987

(in millions of dollars, seasonally unadjusted)

		Exports* (f.a.s.)	Change Over Year-Earlier Period	Imports (Customs)	Change Over Year-Earlier Period	Trade Balance	Imports (c.i.f.)	Change Over Year-Earlier Period	Trade Balance
1983		\$21,894	4.4%	\$41,183	9.1%	\$-19,289	\$43,559	9.1%	\$-21,665
1984		23,575	7.7	57,135	38.7	-33,560	60,371	38.6	-36,796
1985		22,631	-4.0	68,783	20.4	-46,152	72,380	19.9	-49,749
1986		26,882	18.8	81,911	19.1	-55,030	85,457	18.1	-58,575
1987		28,249	5.1	84,575	3.3	-56,326	88,074	3.1	-59,825
1986	January	1,763	-16.0	6,902	15.6	-5,139	7,227	15.1	-5,464
	February	1,813	-0.6	5,861	22.1	-4,048	6,143	21.3	-4,330
	March	1,998	-14.2	7,185	25.5	-5,187	7,518	24.7	-5,520
	April	1,906	10.0	6,333	6.8	-4,427	6,609	6.0	-4,703
	May	1,732	-4.5	6,439	12.6	-4,707	6,725	11.6	-4,993
	June	3,861	120.5	7,240	24.3	-3,379	7,551	22.7	-3,690
	July	2,941	59.4	8,102	49.5	-5,161	8,446	48.0	-5,505
	August	2,272	30.3	6,694	23.0	-4,422	6,973	21.9	-4,701
	September	2,015	4.6	5,884	-8.8	-3,869	6,135	-8.6	-4,120
	October	2,286	24.6	6,996	33.6	-4,710	7,268	32.2	-4,982
	November	1,990	0.9	8,392	38.9	-6,402	8,731	37.7	-6,741
	December	2,305	30.9	5,883	-5.4	-3,578	6,130	-6.3	-3,825
1987	January	1,785	1.3	5,900	-14.5	-4,115	6,146	-15.0	-4,361
	February	2,035	12.3	6,825	16.5	-4,790	7,100	15.6	-5,065
	March	2,139	7.1	6,804	-5.3	-4,665	7,086	-5.8	-4,947
	April	2,171	13.9	6,832	7.9	-4,661	7,117	7.7	-4,946
	May	2,151	24.2	6,934	7.7	-4,783	7,225	7.4	-5,074
	June	2,293	-40.6	7,333	1.3	-5,040	7,638	1.2	-5,345
	July	2,561	-12.9	7,341	-9.4	-4,780	7,635	-9.6	-5,074
	August	2,658	17.0	7,242	8.2	-4,584	7,536	8.1	-4,878
	September	2,424	20.3	6,781	15.3	-4,357	7,057	15.0	-4,633
	October	2,392	4.6	7,932	13.4	-5,540	8,257	13.6	-5,865
	November	2,638	32.6	7,179	-14.5	-4,541	7,485	-14.3	-4,847
	December	3,001	30.2	7,472	27.0	-4,471	7,793	27.1	-4,792

*Domestic and foreign merchandise, including Department of Defense shipments.

Source: Department of Commerce

Table 49: U.S. Exports to Japan by Commodity, 1983-1987

(in millions of dollars, f.a.s. value basis)

	1983	1984	1985	1986	1987
<u>Total Exports to Japan*</u>	<u>\$21,520</u>	<u>\$23,094</u>	<u>\$22,042</u>	<u>\$23,153</u>	<u>\$27,341</u>
<u>Agricultural Commodities</u>	<u>6,241</u>	<u>6,757</u>	<u>5,394</u>	<u>5,088</u>	<u>5,694</u>
<u>Nonagricultural Commodities</u>	<u>15,279</u>	<u>16,337</u>	<u>16,648</u>	<u>18,065</u>	<u>21,647</u>
Food and Live Animals	4,294	4,705	4,011	4,144	4,691
Meat and Meat Products	574	571	541	761	898
Fish and Fish Products	506	503	685	864	1,059
Grain and Cereal Products	2,493	2,873	2,044	1,500	1,595
Wheat	589	534	469	424	352
Corn	1,764	1,999	1,305	878	1,036
Sorghum	86	270	243	178	182
Vegetables and Fruits	419	453	452	584	665
Animal Feeds	159	173	161	233	228
Beverages and Tobacco	442	399	417	390	665
Unmanufactured Tobacco	339	286	302	227	301
Cigarettes	80	95	95	128	492
<u>Inedible Crude Materials</u>	<u>4,185</u>	<u>4,452</u>	<u>3,951</u>	<u>4,068</u>	<u>4,954</u>
Hides and Skins	240	325	298	331	370
Soybeans	1,210	1,173	938	839	786
Synthetic Rubber	47	57	51	66	65
Logs and Lumber	900	841	885	1,097	1,573
Paper Base Stocks	485	528	476	568	757
Raw Cotton	500	605	368	239	414
Steel Scrap	218	265	199	170	123
Nonferrous Ores and Scrap	309	364	460	492	554
<u>Mineral Fuels</u>	<u>1,994</u>	<u>1,812</u>	<u>1,782</u>	<u>1,311</u>	<u>1,297</u>
Bicuminous Coal	1,002	865	769	555	485
Petroleum Products	639	683	762	568	661
<u>Animal and Vegetable Oils and Fats</u>	<u>62</u>	<u>53</u>	<u>51</u>	<u>50</u>	<u>38</u>
<u>Chemicals</u>	<u>2,607</u>	<u>2,961</u>	<u>2,908</u>	<u>3,081</u>	<u>3,422</u>
Chemical Elements and Compounds	1,308	1,553	1,506	1,616	1,702
Organic Chemicals	674	717	704	732	870
Inorganic Chemicals	634	836	802	884	832
Pharmaceuticals	521	553	570	633	680
Fertilizers	110	122	124	99	153
Plastic Materials	345	372	324	336	423
<u>Manufactured Goods Classified</u>					
<u>Chiefly by Material</u>	<u>1,360</u>	<u>1,403</u>	<u>1,244</u>	<u>1,291</u>	<u>1,769</u>
Tires and Tubes	12	11	10	21	62
Paper and Paper Products	294	294	295	361	404
Textiles (excl. clothing)	98	113	108	122	159
Nonmetallic Mineral Products	136	152	150	194	259
Iron and Steel	42	63	48	52	47

(continued)

Table 49: U.S. Exports to Japan by Commodity, 1983-1987 (continued)

(in millions of dollars, f.a.s. value basis)

	1983	1984	1985	1986	1987
Nonferrous Metals and Alloys	\$413	\$379	\$289	\$206	\$394
Copper and Alloys	24	119	16	8	27
Aluminum and Alloys	375	226	258	188	358
Metal Manufactures	191	207	174	194	233
<u>Machinery and Transport Equipment</u>	<u>4,794</u>	<u>5,223</u>	<u>5,751</u>	<u>6,221</u>	<u>7,076</u>
Machinery	3,251	3,897	3,805	4,085	4,794
Power Generating Machinery	517	617	444	497	547
Aircraft Engines and Parts	180	218	295	357	383
Mining and Drilling Machinery and Parts	89	70	69	61	17
Metalworking Machinery	68	77	84	122	100
Heating and Cooling Machinery and Parts	80	79	91	87	97
Centrifuges and Filtering and					
Purifying Machinery and Parts	58	48	49	53	72
Computers, Peripherals and Parts	833	1,057	1,250	1,301	1,626
Telecommunications Equipment	208	206	241	312	409
Other Electric Machinery and Parts	738	930	824	961	1,226
Electric Power Apparatus	141	173	163	178	190
Transport Equipment	1,543	1,327	1,946	2,137	2,283
Road Motor Vehicles and Parts	145	191	214	271	328
Cars	31	29	19	42	72
Automotive Parts (excl. engines,					
tires and electrical parts)	36	34	130	143	138
Aircraft and Parts	1,345	1,073	1,710	1,826	1,893
Commercial Aircraft	835	541	906	1,161	1,095
Aircraft Parts	498	519	574	654	796
<u>Miscellaneous Manufactured Goods</u>	<u>1,367</u>	<u>1,479</u>	<u>1,483</u>	<u>1,801</u>	<u>2,383</u>
Clothing	44	43	34	46	98
Professional, Scientific and Medical Equipment					
and Measuring and Controlling Instruments	583	645	691	736	907
Photographic Supplies	221	225	219	267	270
Printed Material	55	66	60	64	78
Rubber and Plastic Products	69	74	72	80	102
Toys and Sporting Goods	114	89	80	98	180
Musical Instruments and Parts	82	91	93	137	197
<u>Unclassified Commodities</u>	<u>121</u>	<u>204</u>	<u>258</u>	<u>535</u>	<u>1,046</u>

*Domestic merchandise only, including Department of Defense shipments.

Source: Department of Commerce

Table 50: U.S. Imports from Japan by Commodity, 1983-1987

(in millions of dollars, c.i.f. value basis)

	1983	1984	1985	1986	1987
<u>Total Imports from Japan</u>	<u>\$43,559</u>	<u>\$60,371</u>	<u>\$72,380</u>	<u>\$85,457</u>	<u>\$88,074</u>
<u>Agricultural Commodities</u>	186	243	269	291	239
<u>Nonagricultural Commodities</u>	<u>43,373</u>	<u>60,129</u>	<u>72,111</u>	<u>85,166</u>	<u>87,835</u>
<u>Food and Live Animals</u>	366	436	488	476	418
<u>Fish and Fish Products</u>	236	265	297	276	237
<u>Beverages and Tobacco</u>	28	39	39	46	53
<u>Inedible Crude Materials</u>	81	94	120	113	139
<u>Mineral Fuels</u>	12	59	67	75	92
<u>Animal and Vegetable Oils and Fats</u>	7	8	9	12	18
<u>Chemicals</u>	1,172	1,403	1,506	1,896	2,271
<u>Chemical Elements and Compounds</u>	584	673	731	902	1,065
Organic Chemicals	459	548	599	772	886
Inorganic Chemicals	125	125	132	130	179
<u>Pharmaceuticals</u>	84	78	87	127	158
<u>Manufactured Goods Classified</u>					
<u>Chiefly by Material</u>	5,667	7,872	8,222	7,384	7,069
<u>Tires and Tubes</u>	455	583	630	635	663
<u>Paper and Paper Products</u>	78	99	130	163	202
<u>Textiles (excl. clothing)</u>	620	717	764	908	802
Yarn	73	93	77	91	86
Cotton Fabrics	70	119	152	173	158
Other Fabrics	347	350	362	455	384
<u>Glass, Glassware and Tableware</u>	452	532	580	596	574
<u>Steel Mill Products</u>	2,117	3,453	3,344	2,454	2,427
Wire Rods and Bars	376	553	506	384	440
Plates and Sheets	1,103	1,739	1,564	1,329	1,405
Tubes, Pipes and Fittings	462	864	971	506	382
<u>Nonferrous Metals and Alloys</u>	411	531	561	532	478
Copper and Alloys	113	121	115	130	153
Aluminum and Alloys	233	346	363	347	257
<u>Metal Manufactures</u>	1,179	1,457	1,689	1,642	1,512
<u>Machinery and Transport Equipment</u>	31,783	44,662	54,842	67,266	69,447
<u>Machinery</u>	15,924	25,535	29,642	34,699	36,858
Power Generating Machinery	880	1,332	1,510	2,016	2,472
Agricultural Machinery and Tractors	246	373	422	510	523
Textile and Sewing Machinery	205	258	257	329	385
Metalworking Machinery	641	937	1,306	1,550	1,441
Office Machinery and Computers	3,389	5,454	5,843	7,551	9,147
Telecommunications Equipment	5,856	9,125	11,549	12,684	10,838
Radio Sets	254	295	316	279	277
Television Sets	435	706	851	890	520

(continued)

Table 50: U.S. Imports from Japan by Commodity, 1983-1987 (continued)

(in millions of dollars, c.i.f. value basis)

	<u>1983</u>	<u>1984</u>	<u>1985</u>	<u>1986</u>	<u>1987</u>
Stereo Equipment and Audio and Video Cassette Recorders	\$2,400	\$3,839	\$5,368	\$5,961	\$4,130
Other Electric Machinery and Parts	3,026	5,079	4,915	5,646	6,812
Transport Equipment	15,859	19,127	25,200	32,567	32,589
Road Motor Vehicles	13,756	16,244	21,669	27,891	27,194
Cars	10,963	13,038	17,126	22,011	22,162
Automotive Parts (excl. engines, tires and electrical parts)	931	1,622	2,125	3,260	4,075
Motorcycles and Parts	785	699	940	891	578
Aircraft and Parts	143	133	134	176	247
<u>Miscellaneous Manufactured Goods</u>	<u>4,069</u>	<u>5,383</u>	<u>6,327</u>	<u>7,342</u>	<u>7,707</u>
Clothing	361	527	519	491	399
Professional, Scientific and Controlling Instruments	531	794	977	1,159	1,248
Clocks and Watches	343	447	490	487	536
Printed Matter	108	148	166	213	224
Toys and Sporting Goods	322	416	592	555	770
<u>Unclassified Commodities</u>	<u>374</u>	<u>416</u>	<u>760</u>	<u>849</u>	<u>861</u>

Source: Department of Commerce

Table 51: U.S. Direct Investment Position Abroad,
Year-End 1983-1987

	(in millions of dollars)				
	1983	1984	1985	1986	1987
Developed Countries	\$155,736	\$157,123	\$172,058	\$194,691	\$233,315
Canada	44,339	46,730	46,909	49,994	56,879
United Kingdom	27,637	28,553	33,024	35,692	44,673
West Germany	15,319	14,823	16,764	20,846	24,450
Switzerland	14,099	14,725	15,766	17,842	19,973
Japan	7,661	7,936	9,235	11,332	14,270
Netherlands	6,613	5,839	7,129	11,618	14,164
France	6,614	6,406	7,643	8,857	11,478
Australia	9,005	8,918	8,772	9,120	10,988
Italy	4,461	4,594	5,906	6,935	8,449
Belgium	4,438	4,584	5,038	5,229	7,078
Ireland	2,460	2,869	3,693	4,395	5,484
Norway	3,094	2,841	3,215	3,626	4,142
Spain	2,287	2,139	3,693	2,612	4,037
Developing Countries	45,746	49,153	52,764	60,270	71,174
Bermuda	11,056	13,019	13,116	14,765	18,229
Brazil	9,068	9,237	8,893	9,187	9,955
Hong Kong	3,068	3,253	3,295	3,980	5,453
Mexico	4,381	4,597	5,088	4,750	4,997
Panama	4,837	4,474	3,959	4,293	4,780
Indonesia	2,770	4,093	4,475	4,395	3,929
International	5,721	5,204	5,428	4,602	4,304
Total	207,203	211,480	230,250	259,562	308,793
of which:					
Petroleum	57,574	59,051	57,695	61,731	66,381
Manufacturing	82,907	85,865	94,700	104,877	126,640
Wholesale Trade	21,278	21,117	22,790	26,168	31,330
Banking	12,387	13,516	14,461	14,576	15,354
Finance, Insurance					
and Real Estate	15,075	15,683	22,501	34,413	49,097
Services	4,670	4,447	4,683	4,866	6,812
Other	13,312	12,799	13,421	12,931	13,179

Source: Department of Commerce

Table 52: U.S. Direct Investment Position in Japan,
Year-End 1983-1987

	(in millions of dollars)				
	1983	1984	1985	1986	1987
Total	\$7,661	\$7,936	\$9,235	\$11,332	\$14,270
Petroleum	1,902	2,052	2,184	2,612	2,561
Manufacturing	3,915	4,076	4,584	5,443	7,073
Food Products	155	66	128	157	365
Chemicals	1,148	1,211	1,311	1,591	2,093
Metals	79	47	82	130	173
Nonelectric Machinery	1,270	1,341	1,664	1,812	*
Electric Machinery	312	409	331	475	625
Transport Equipment	480	481	625	699	546
Other	471	522	443	580	*
Wholesale Trade	1,252	1,196	1,581	2,179	2,934
Banking	176	176	178	192	343
Finance, Insurance					
and Real Estate	325	347	520	648	945
Services	21	31	83	108	154
Other	69	58	104	149	260

*Suppressed to avoid disclosure of data on individual companies.

Source: Department of Commerce

Table 53: Foreign Direct Investment Position in the United States, Year-End 1983-1987

(in millions of dollars)

	1983	1984	1985	1986	1987
United Kingdom	\$32,152	\$38,387	\$43,555	\$55,935	\$74,941
Netherlands	29,182	33,728	37,056	40,717	47,048
Japan	11,336	16,044	19,313	26,824	33,361
Canada	11,434	15,286	17,131	20,318	21,732
West Germany	10,845	12,330	14,816	17,250	19,637
Switzerland	7,464	8,146	10,568	12,058	14,343
France	5,726	6,591	6,670	7,709	10,195
Netherlands Antilles	9,948	10,935	10,443	9,685	8,895
OPEC Countries	4,039	4,892	4,607	4,787	4,981
Total	137,061	164,583	184,615	220,414	261,927
of which:					
Mining	1,928	3,920	4,039	5,080	5,619
Petroleum	18,209	25,400	28,270	29,094	35,395
Manufacturing	47,665	51,802	59,584	71,963	91,025
Wholesale Trade	21,031	24,455	29,051	33,997	37,580
Retail Trade	5,482	6,764	6,822	8,923	9,546
Banking	8,697	10,326	11,377	12,394	13,848
Finance	2,269	5,633	4,246	7,239	7,982
Insurance	8,665	8,922	11,806	15,345	15,951
Real Estate	14,636	17,761	19,402	22,512	24,478
Other	8,478	9,599	10,019	13,868	20,502

Source: Department of Commerce

Table 54: Japan's Foreign Direct Investment Position in the United States, Year-End 1983-1987

(in millions of dollars)

	1983	1984	1985	1986	1987
Total	\$11,336	\$16,044	\$19,313	\$26,824	\$33,361
Mining	*	7	7	*	*
Petroleum	-408	-88	31	34	30
Manufacturing	1,605	2,460	2,738	3,578	5,232
Food Products	186	186	159	158	164
Chemicals	283	252	268	279	534
Metals	140	541	562	471	577
Machinery	466	628	715	1,052	1,521
Other	530	853	1,033	1,618	2,436
Wholesale Trade	7,823	9,689	11,796	13,687	14,667
Retail Trade	234	252	251	290	320
Banking	1,384	1,853	2,160	2,704	3,402
Finance	*	513	51	2,087	2,643
Insurance	182	138	119	*	*
Real Estate	515	744	1,536	2,941	4,431
Other	430	475	622	1,306	2,367

*Suppressed to avoid disclosure of data on individual companies.

Source: Department of Commerce

J A P A N · E C O N O M I C · I N S T I T U T E

JEI

R E P O R T

A Two-Part Report: A and B

NO. 37B
September 30, 1988

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Japan's Economy Appears To Stumble In Second Quarter

At first the news seemed too good to be true. In 1988's first quarter Japan's price-adjusted gross national product reportedly streaked ahead at an 11.2 percent annualized clip. The bad news that followed three months later was equally lacking in credibility. In the just released data for the period from April through June, real GNP appeared to contract 3.9 percent (see Table).

What happened? Neither set of figures is as outlandish as it appears. One of the culprits is the calendar. With an extra day for leap year in the first quarter and fewer working days than normal in the second because of a

Japan's Real Gross National Product at Constant (1980) Prices

- (in billions of yen, seasonally adjusted, quarterly totals and rates of growth at annual rates)

	FY 1986	FY 1987	July- September 1987	October- December 1987	January- March 1988	April- June 1988
Gross National Product	Y301,679.7 (2.6%)	Y316,588.6 (4.9%)	Y313,030.0 (8.4%)	Y318,776.3 (7.5%)	Y327,320.1 (11.2%)	Y324,086.8 (-3.9%)
Personal Consumption Spending	169,195.1 (3.6%)	175,903.9 (4.0%)	174,877.5 (4.2%)	175,663.0 (1.8%)	180,134.2 (10.8%)	181,223.6 (2.1%)
Private Residential Construction	15,637.9 (10.9%)	19,368.0 (23.9%)	18,679.1 (47.5%)	21,042.6 (61.1%)	21,250.9 (4.0%)	19,254.2 (-32.6%)
Private Fixed Nonresidential Investment	56,361.2 (4.5%)	62,107.9 (10.2%)	60,554.5 (11.2%)	63,065.7 (17.6%)	65,450.6 (16.0%)	68,430.4 (19.7%)
Change in Business Inventories	515.2 (*)	974.1 (*)	716.3 (*)	1,172.2 (*)	1,082.7 (*)	1,722.4 (*)
Government Current Expenditures	29,002.0 (6.8%)	28,779.3 (-0.8%)	28,648.5 (-1.1%)	28,706.9 (0.8%)	29,028.8 (4.6%)	29,133.8 (1.5%)
Government Fixed Investment	22,162.2 (6.6%)	24,558.9 (10.8%)	23,496.0 (12.8%)	25,046.4 (29.1%)	26,045.3 (16.9%)	25,265.6 (-11.1%)
Change in Government Inventories	816.0 (*)	41.5 (*)	-9.2 (*)	-163.3 (*)	452.3 (*)	60.1 (*)
Net External Sector	7,990.1 (-35.0%)	4,855.0 (-39.2%)	6,067.3 (52.0%)	4,242.8 (-76.1%)	3,875.3 (-30.5%)	-1,003.3 (-99.6%)
Exports of Goods and Services and Factor Income Received	52,689.5 (-3.6%)	55,372.7 (5.1%)	55,981.6 (29.6%)	55,472.2 (-3.6%)	57,714.7 (17.2%)	55,499.3 (-14.5%)
Imports of Goods and Services and Factor Income Paid	44,699.5 (5.5%)	50,517.7 (13.0%)	49,914.3 (27.2%)	51,229.4 (11.0%)	53,839.4 (22.0%)	56,502.6 (21.3%)

*Cannot be calculated or meaningless.

Source: Economic Planning Agency

longer-than-usual holiday season, the GNP figure was distorted upward in the January-March period and downward in the April-June quarter. The effect was to overstate the rate of growth in the first quarter and to understate it in the second, although probably not by enough to remove the difference in the growth rates entirely. Certainly on a year-to-year basis the economy still looks strong, with the second quarter 5.3 percent ahead of a year earlier.

The pattern of growth in the April-June period, if not its rate, showed a familiar pattern. For the third straight quarter, net external demand was a drag on overall growth, but the effect was far larger than previously. Imports adjusted for price changes soared 21.3 percent from the January-April level, while the volume of exports plummeted 14.5 percent. The result was that net exports shaved 1.5 percentage points off the overall quarterly growth rate, resulting in a rate of -1 percent.

This left domestic demand with a 0.5 point contribution to the quarterly growth rate. In fact, though, total government spending declined, knocking 0.3 point off overall growth. That made private domestic spending the one bright spot, with an 0.8 point contribution. The figures, in other words, underscored the economy's underlying strength; the economy was strongest where it most needed to be. Barring further bumps in the data, this suggests future quarterly figures could show gains without continuous doses of government stimulus or boosts in exports.

Within the private sector, corporate investment rather than housing was the principal engine of growth, a pattern apparent in the previous quarter. Housing declined at an annualized 32.6 percent rate, while private plant and equipment investment was up 19.7 percent. Consumer spending, which by itself accounts for about 56 percent of the whole economy, increased a scant 2.1 percent, although it may have been affected more by the ravages of the calendar than most other figures.

The figures just released are the first installment of GNP data for FY 1988. While the negative growth in the April-June period would appear to make the government's outlook for 3.8 percent real growth in FY 1988 harder to reach, private forecasters so far have not altered their own forecasts, which generally have been more optimistic than the government's. Even after seeing the latest GNP figures, many analysts are still projecting fiscal year growth in excess of 5 percent.

Their optimism is based in part on more recent data than the GNP figures. For example, seasonally adjusted electric power usage, after stagnating in the April-June period, rose again in both July and August. Some analysts are already forecasting a return to positive GNP growth in the July-September quarter. And some indicators of future activity are at record levels. For example, the Bank of Japan's index of business sentiment (those responding that conditions will be favorable less those saying unfavorable) is a positive 42 for December, one of the highest readings in recent memory.

The recently enacted tax cut, with an estimated impact in FY 1988 of ¥1.27 trillion (\$10.2 billion at \$1.00=¥125), will give the economy a small additional boost (see JEI Report No. 30B, August 5, 1988). By contrast, the April-June GNP figures reflect a trailing off of the effects of the 1987 fiscal stimulus package of spending increases and tax cuts.

Generally, the watchword for the immediate future is stable growth. The Economic Planning Agency minimized the significance of the latest GNP figures and suggested that growth will continue. In this view, the latest data are a shot across the bow -- not about impending weakness in the economy but about reading too much into a single set of numbers.

Douglas Ostrom

Manufactured Imports Increasing

One of the persistent complaints about Japan's trade structure has been that the country's imports of manufactured goods are far too low. As a country poor in natural resources, the argument goes, Japan naturally has to import raw materials, but as a wealthy country with a large trade surplus that can afford a little luxury, it should import more manufactured goods to complement its own formidable production. The result would be lower prices and better variety for Japanese consumers, cheaper inputs for some manufacturers and reduced trade frictions.

Over time Japan's imports of manufactured goods have shown a tendency to rise as a percentage of total imports, although the level is still lower than that of other industrialized countries (see JEI Report No. 14A, April 8, 1982). Recent data confirm the long-term trend. During the first half of 1988, manufactured goods imports soared 49.4 percent in dollar terms and 36.8 percent in volume. For this period manufactures represented 48.1 percent of all imports, up from 43.2 percent in the first six months of 1987.

A disproportionate share of the increase in manufactured imports came from the overseas subsidiaries of Japanese firms, especially those located in Asia's newly industrializing economies. This trend is likely to continue. In a survey by the Economic Planning Agency, 37.3 percent of responding manufacturing firms with offshore production facilities said that they plan to initiate or increase imports into Japan from their overseas plants. Of course, they did not specify how much they would sell in Japan. Moreover, 58.9 percent of the companies indicated they have no plans to source products from their facilities abroad.

As the yen has appreciated, imports have become cheaper for Japanese customers. As a result, the manufactured import penetration of the Japanese economy has actually declined by some measures, at least until recently, even as the real rate of import growth has exceeded that of the economy as a whole. Between 1985 and 1987, the Bank for International Settlements estimates, imports of finished manufactured goods as a percentage of value-added in Japanese manufacturing declined from 10.2 percent to 9.6 percent. According to the Ministry of Finance, price-adjusted imports of manufactured goods increased 37.9 percent during this period.

Despite their still modest level, manufactured imports may be complicating the way the Japanese economy operates. A Sanwa Bank, Ltd. report suggests that rising product imports have altered the nature of adjustment to changing demand in the steel industry and elsewhere. In the past, falling steel inventory levels -- a result of surging demand -- would lead to a combination of

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A Two-Part Report: A and B

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THE MAEKAWA REPORTS: REALITY OR RHETORIC?

Summary

The rapid and persistent expansion of Japan's current account surplus in the 1980s signaled that the policies the country had pursued for 35 years were no longer compatible with stable world growth. Domestic and external pressures for reform bore fruit in 1986 with the release of the first so-called Maekawa report. Calling for nothing less than a complete restructuring of Japan's economy, its people's lifestyle and the country's global role, the report crystallized the issues facing the nation. While the concepts contained in the Maekawa reports (a follow-up report was issued in 1987) were hailed inside and outside Japan, many wondered whether the Japanese would take the ideas to heart. Two-and-a-half years after the first Maekawa report, many recommendations have become reality. The true test of the report's impact is yet to come, however, since most of the difficult and wrenching changes remain to be attempted.

The 1980s: Turning Point for Japan

Japan's total output of goods and services between 1970 and 1980 nearly doubled in size relative to the United States' (see Table 1). Then, after holding in the 40-percent range in the early 1980s, the Japan/U.S. gross national product ratio suddenly shot up in 1986 and 1987. Although much of the increase was due to the appreciation of the yen against the dollar, the fact that Japan's economy was now nearly two-thirds the size of America's drove home the point that Japan was no longer a small player in the global marketplace.

Coupled with this increase in relative economic size came a rapid widening of the current account imbalances of Japan, the United States and West

Germany. In the 1970s Japan's modest trade surpluses combined with deficits in services and invisibles to yield moderate current account balances that were in deficit almost as often as in surplus (see Table 2). This pattern held until 1983 when the recovering U.S. economy and a stronger dollar made Japanese exports more competitive in the American market and U.S. exports to Japan more expensive. The U.S. consumption binge drove American and Japanese current account balances in opposite directions to record levels. The magnitude and persistence of these imbalances led to heightened trade frictions between Japan and its major trading partner.

Mirroring the patterns in goods trade, Japan's financial markets began to assert themselves globally. The growing Japanese economy generated internal and external pressures for the reform of financial regulations. At home, bulging corporate coffers, burgeoning government debt recycling demands and increasingly multinational corporate operations led a broad coalition of financial and nonfinancial companies to press Tokyo for changes. At the same time, Japan's expanding economy acted as a magnet, attracting increased interest from foreign firms. In order for domestic as well as foreign companies to operate more efficiently in Japan, a broad program of deregulation was critical.

The government found itself increasingly out of step with the new economic needs. The panoply of regulations that had insulated the country from external disturbances -- or moderated their impact -- during the difficult period after World War II had become a stifling blanket, threatening to strangle the competitive vitality and technological innovation universally viewed as the key to Japan's future prosperity. The government's continued control of the domestic telecommunications market (through Nippon Telegraph and Telephone Public Corp.), a large part of the country's railroads (Japanese National Railways), and the domestic tobacco market (Japan Tobacco and Salt Public Corp.) became symbols of how the government was obstructing economic progress.

The central government general account budget deficit also drew criticism as the cost of servicing the outstanding debt escalated. Up until the mid-1960s Tokyo's balanced budget minimized debt concerns. After a brief surge in the deficit to counteract the 1965-67 economic slowdown, Tokyo limited new debt issues to well under 10 percent of the annual budget until 1971. In response to the twin oil shocks and ensuing global recession, however, Tokyo embarked on a strongly stimulative fiscal policy. The share of the annual general account budget financed through borrowing rose rapidly from 4.2 percent in FY 1970 to 12.4 percent in FY 1971, reaching 25.4 percent in FY 1975 and hitting a high point in FY 1979 at 34.7 percent. By 1980 the outstanding debt was equivalent to 29.3 percent of gross national product, and debt service outlays had risen to 14.2 percent of the annual budget. As the debt issued in the early 1970s came due, the debt-to-GNP ratio topped 40 percent in FY 1984. It has remained there, equaling the scale of the U.S. budget deficit.

By the mid 1980s, therefore, Japan had reached a critical point. Old policies and regulations, which had served so well in rebuilding the war-torn economy, were no longer suitable or could not be maintained. Furthermore, conflicting information bombarded the average Japanese worker. On the one hand, the Japanese press and the government loudly trumpeted Japan's new status as an

Table 1: Real Gross National Product, Japan and the United States*

(in billions of dollars and percent)

<u>Year</u>	<u>United States</u>	<u>Japan</u>	<u>Japan/United States Ratio</u>
1955	\$1,281.4	\$93.0	7.3%
1960	1,427.4	139.8	9.8
1965	1,789.4	251.0	14.0
1970	2,071.1	422.8	20.4
1975	2,310.1	634.1	27.4
1980	2,732.0	1,058.1	38.7
1981	2,784.7	1,127.8	40.5
1982	2,713.8	1,029.4	37.9
1983	2,810.7	1,114.5	39.7
1984	2,991.4	1,171.0	39.1
1985	3,093.3	1,220.8	39.5
1986	3,150.1	1,771.0	56.2
1987	3,274.9	2,153.9	65.8

*1980 prices.

Source: International Monetary Fund, International Financial StatisticsTable 2: Japan's Trade and Current Account Balances, 1970-87

(IMF basis, millions of dollars)

<u>Year</u>	<u>Exports</u>	<u>Imports</u>	<u>Trade Balance</u>	<u>Current Account Balance</u>
1970	\$18,969	\$15,006	\$3,963	\$1,970
1971	23,566	15,779	7,787	5,797
1972	28,032	19,061	8,971	6,624
1973	36,264	32,576	3,688	-136
1974	54,480	53,044	1,436	-4,693
1975	54,736	49,706	5,028	-682
1976	66,026	56,139	9,887	3,680
1977	79,333	62,022	17,311	10,918
1978	95,634	71,038	24,593	16,534
1979	101,232*	99,387*	1,845*	-8,754
1980	126,736	124,611	2,125	-10,746
1981	149,522	129,555	19,967	4,770
1982	137,663	119,584	18,079	6,850
1983	145,468	114,014	31,454	20,799
1984	168,290	124,033	44,257	35,003
1985	174,015	118,029	55,986	49,169
1986	205,591	112,764	92,827	85,845
1987	224,605	128,219	96,386	87,015

*Processing fees and net receipts on merchandise transactions excluded from export, import and trade balance data from July 1979.

Source: Ministry of Finance

economic superpower. On the other, the nation's standard of living remained well beneath that enjoyed in Western industrialized countries. This discrepancy generated calls for the country to turn its attention to the quality of life rather than overall economic growth.

The Maekawa Commission

Responding to these forces, then-Prime Minister Yasuhiro Nakasone commissioned a personal advisory panel October 31, 1985 to study what Japan should do to meet its new international and domestic obligations. Haruo Maekawa, former governor of the Bank of Japan, chaired a commission of appointees with reputations for open minds and forward thinking in their fields of business, academia and government. After a little more than five months of work, the panel released its first report April 7, 1986. It called not just for new policies but for a thorough restructuring of the nation's economic structure.

The Advisory Group on Economic Structural Adjustment for International Harmony, as the Maekawa commission was formally known, set a new goal for the nation: to steadily reduce the huge current account surplus to one consistent with international harmony. (For a complete summary of the first report, see the Appendix). Linking the imbalance to "Japan's economic structure, which is export-oriented," the group called for a structure "oriented toward international coordination" but one that also enhances "the quality of the nation's living standard." The restructuring effort should be based on three principles, the report said: the use of open market mechanisms wherever possible; the coordination of domestic restructuring with the adjustment policies of foreign nations; and the consideration of restructuring as a long-term, continuous process, but one that must be started immediately.

The panel's recommendations will be dealt with in detail later in this report. Briefly, the main points were:

- Expand domestic demand to reduce dependence on external demand and improve national living standards. This includes promoting housing development, stimulating other forms of private consumption and encouraging investment in social infrastructure.
- Restructure domestic industry to match new economic conditions. This section encourages firms to focus on meeting domestic rather than external demand, promotes direct investment abroad and urges more imports of agricultural goods.
- Increase imports of manufactured goods. Reducing tariffs, streamlining standards and certification procedures, simplifying the distribution system and pursuing antimonopoly policies are some domestic tasks. Internationally, Japanese companies should promote technology exports, engage in more cooperative ventures and refrain from disruptive behavior, such as the pursuit of "expanded market share at all costs."
- Stabilize exchange rates and liberalize capital markets. International policy coordination is the key to achieving steady exchange rates, particularly in the "elimination of major disparities in the economic performance of leading industrialized countries" that generate pressure for realignment. Japan's financial role must be "commensurate with its economic importance." Diversification of instruments and proliferation of secondary markets are important goals.

- Promote international cooperation and contribute to the world economy in line with its new position. Japan must play a larger role in aiding developing countries, solving the Third World debt problem, providing foreign aid, promoting scientific and cultural exchanges, and supporting the current round of multilateral trade negotiations under the auspices of the General Agreement on Tariffs and Trade (the Uruguay Round).

- Pursue flexible fiscal and monetary policies while reducing the national budget deficit. Not only must the government "end its dependency on deficit financing bonds," but it must "achieve economic and social balance" while mobilizing "private sector vitality" through deregulation. On top of this, the tax system should be reviewed with an eye toward equity, fairness and simplicity. Incentives for saving also should be reduced.

The initial international reaction to the first Maekawa commission report was positive but cautious. U.S. administration and congressional observers agreed that the report could indeed represent a "historical transformation" of Japan's economy if fully implemented. The reaction from Europe was similar. Hailing the ideas, West Germany, France and the European Commission were willing to give Japan a chance but waited for action before making a final judgment. Britain, on the other hand, brushed off the report because it lacked specific details.

The domestic response was even less assuring. Candidates for Mr. Nakasone's job within his own Liberal Democratic Party blasted the ideas; ironically, they felt there was too much detail. Anxieties heightened when Mr. Nakasone "explained" the report to President Reagan since the politicians were concerned that Mr. Nakasone had committed the nation to actions that were still being discussed. The business community also was ambivalent, with many pointing out that the report's recommendations could lead to increased unemployment, higher business taxes and reduced international competitiveness. Businessmen did admit that it might be time for the Japanese to begin enjoying life a little more, but they were widely split as to the wisdom of dropping incentives to save.

To address the foreign concern about a dearth of specifics and the domestic political realities that require a national consensus before shifting policies, Mr. Nakasone asked Mr. Maekawa to continue to study the problem and to develop more concrete details under the auspices of a government advisory body, the Economic Council. (The fact that the first Maekawa panel was merely an informal advisory body to the prime minister detracted from its message.) The result, drawn up by the Special Committee on Economic Restructuring, was released almost exactly one year after the initial report -- April 23, 1987. (See the Appendix for a full summary of the second Maekawa report.) It added the following points to the first report's framework:

- The government should promote domestic demand by increasing funding support and tax breaks for home buyers as well as encouraging more companies to enter the homebuilding market to enhance competition and supply.

- Land use must be reconsidered, including agricultural land in urban areas, urban redevelopment and the use of landfills. Government also must aid depressed regions of Japan and strive to develop attractive alternatives to Tokyo and other existing metropolitan centers.

- The government should promote domestic consumption by seeking adequate wage growth and price stability and ensuring that the benefits of the yen's appreciation are passed on to the consumer, particularly where government corporations are involved.

- The government should help shorten the workweek by setting a national average of 1,800 work hours a year plus 20 days of vacation annually by the year 2000. To deal with unemployment that may be induced by restructuring, a "Japanese worksharing" system featuring shorter hours and a "redistribution of employment across generational lines" was urged.

- The "hollowing out" of the Japanese economy as a result of the restructuring process should be discounted. This idea reflects old economic realities and does not meet with current or future needs, the report said.

- Reform was targeted for the distribution system plus the petroleum, construction, agriculture, transportation and telecommunications industries. In regard to agriculture, the report recommended improving government controls "so as to expand trading in independent-market rice, [and] to introduce competitive principles in all stages from collection to marketing." The explicit mention of this politically sensitive domestic issue is worth noting. At the same time, however, the report also called for steps "to establish agriculture as a viable industry." Greater emphasis on consumer concerns and reducing the gap between domestic and foreign prices for food items were two other areas of importance.

- Japan must increase its role in supporting global free trade, solving the Third World debt crisis and providing development assistance. The report also called for a greater Japanese role in adding to mankind's basic scientific understanding, supplying "international public works" and revitalizing "Japanese education with expanded acceptance of foreign educators and educational and research institutions."

This follow-up report was applauded overseas for its suggestions as well as its ideas. Along with specific steps, it set deadlines for some goals. While foreigners found this encouraging, the Japanese public was suspicious of such detail since many uncontrollable and unpredictable factors are involved. Nevertheless, the recommendations matched the mood of the nation and helped spur further debate.

It is clear that the second Maekawa report went beyond targeting critics who wanted details, however. When members of the second commission met with Prime Minister Nakasone to review the report, they openly criticized the government as a captive of vested interests. Frustration with the government's failure to act on the ideas encompassed in the first report during the intervening 12-month period was evident in the second report's listing (and repeating) a number of specific steps that the government should take.

Maekawa at Two-and-a-Half: The Reality

In examining what Japan has done to implement the Maekawa recommendations, three points should be kept in mind. First, only 30 months have passed since the first report was issued, even less if the year between reports is discounted. It would be unrealistic to expect Japan to restructure within 30 months an economic edifice that took 40 years to build. It would be equally fantastic to expect the speedy development of a national consensus on policy

changes that reflect the nature of Japan's new global role. Second, the report's ideas corresponded to moves that had already been taken in several areas, the most important being financial liberalization. In these areas, near-complete implementation is not surprising. Finally, many of the objectives are beyond Tokyo's control. The report deals with the behavior not only of Japanese corporations but also of individual citizens and foreign countries. To expect these entities to modify their actions to conform to the Maekawa recommendations may be asking too much.

To evaluate Japan's progress toward the Maekawa goals, each point of the initial report will be examined in the original order with two exceptions: evaluations of the ultimate goals and overall principles will be reserved for last. Where appropriate, objectives or recommendations from the second report also will be included in an attempt to provide a unified picture.

Expanding domestic demand - While it really is too early to tell for sure, initial signs are modestly encouraging that domestic demand is playing a bigger -- indeed, the dominant -- role in growth. Domestic demand actually has accounted for the majority of Japanese growth in all but three years since 1966 (see Table 3). The true impact of external demand, however, is masked since it is impossible to separate the amount of domestic capital formation intended to produce exports from that designed to supply the domestic market. From another

Table 3: Contribution to Real Gross National Product Growth, 1966-87

(in percent)

<u>Year</u>	<u>GNP Growth</u>	<u>Domestic Demand</u>	<u>Net External Demand</u>
1966	10.5%	10.8%	-0.3%
1967	10.4	12.8	-2.4
1968	12.5	12.4	0.1
1969	12.1	12.2	-0.1
1970	9.5	10.9	-1.4
1971	4.3	3.7	0.6
1972	8.5	9.5	-0.9
1973	7.9	10.9	-3.0
1974	-1.4	-2.6	1.2
1975	2.7	0.7	1.9
1976	4.8	3.8	1.0
1977	5.3	4.5	0.9
1978	5.2	6.1	-0.9
1979	5.3	6.7	-1.4
1980	4.3	0.9	3.4
1981	3.7	2.2	1.5
1982	3.1	2.8	0.3
1983	3.2	1.7	1.5
1984	5.1	3.7	1.3
1985	4.7	3.7	1.0
1986	2.4	3.9	-1.4
1987	4.2	4.9	-0.7

Note: Figures may not add up due to rounding.

Source: Economic Planning Agency

standpoint, while consumer spending picked up some steam between 1984 (a 2.7 percent gain in price-adjusted terms) and 1987 (a 3.9 percent increase), the growth in this component has generally been smaller than the overall rate of GNP expansion (except in 1986 when personal consumption rose 3.2 percent and overall real growth was only 2.4 percent).

In terms of expenditures by average households, the picture is also mixed (see Table 4). Expenditure growth slowed to a crawl in 1987, both in nominal and real terms, while savings continued to increase. On the other hand, retail stores and supermarkets report that sales have risen steadily in 1988. The stability of consumer prices has been remarkable in comparison to other industrialized countries, but the Maekawa commission called for more. Analysts argue, for example, that the gains from the appreciation of the yen must be passed on to the consumer. Tokyo has done what it can by encouraging utilities to reduce rates as the yen cost of imported energy has plunged and by urging distributors and retailers to reduce prices on imported goods as much as possible. The jawboning is having some effect, but there is widespread agreement that more needs to be done in order to achieve the Maekawa goals. According to the Bank of Japan, import prices dropped 35.8 percent in 1986 and another 8.3 percent in 1987 while domestic wholesale prices fell only 4.7 percent and 3.1 percent, respectively. On certain imported items, however, Tokyo claims that as much as 60 percent of the benefits of the yen's appreciation has been passed on to the consumer.

Table 4: Changes in Income and Expenditure by Workers' Households, 1982-87

(percent change from previous year)

<u>Year</u>	<u>Income</u>	<u>Living Expenditure</u>	<u>Recreation</u>	<u>Savings</u>	<u>Consumer Price Index</u>
1982	7.1%	7.5%	6.5%	1.4%	2.8%
1983	3.2	3.1	3.1	7.8	1.8
1984	4.6	4.1	5.0	0.1	2.3
1985	9.7	3.8	2.6	16.2	2.0
1986	1.8	1.8	3.5	6.4	0.6
1987	1.7	0.6	-0.3	6.7	0.1

Source: Statistics Bureau, Management and Coordination Agency

Ambiguity in the consumption data points to one area where Japan has failed to measure up to the Maekawa report: wage increases. Wages and productivity growth seem to have no relation. In annual negotiations labor unions have been unable to win increases that match, much less surpass, productivity advances. The government has been urging the business community to be more generous, but it is also sympathetic to claims that excessive wage growth will reduce Japan's international competitiveness. The capture by corporations rather than workers of productivity gains would seem to work against greater personal consumption and improved living standards as urged by the Maekawa reports.

Efforts to increase home ownership have been made, but the impact is questionable. Tokyo has increased the funds available for home buyers through

the government's Home Finance Corp.; it also is permitting banks to securitize home loan portfolios to increase such lending. Private residential construction has made a positive contribution to GNP growth since 1985, especially in 1987 when it recorded 20.6 percent real growth. However, problems remain. While the government took measures to curb skyrocketing land and housing prices in the Tokyo metropolitan area in 1987, housing in this market remains out of the reach of most Japanese. The continuous growth of Tokyo -- the most populous region of the country -- has become a major problem. In addition, little has been done to encourage new firms to enter the homebuilding market, a suggestion of the second Maekawa report. There is disagreement as to whether such promotion is necessary, given the large number of contractors in Japan, but Tokyo may take action if the variety of available housing does not increase in coming years.

Working hours generally continue at previous levels despite jawboning by Tokyo. The average Japanese still puts in over 2,100 hours a year, while his American counterpart puts in around 1,900 hours and a West German worker just under 1,700. Banks have just begun to close on Saturdays, and government offices will follow soon. Japanese manufacturers, worried about international competitiveness, are likely to be the last to climb on board; average hours worked in the manufacturing sector actually rose in 1987. It will be a long haul to attain the Maekawa report's goal of 1,800 hours of work a year plus 20 days of vacation.

Restructuring domestic industry - This is certainly one of the most difficult objectives, and one that takes time. According to the Ministry of International Trade and Industry (Table 5), the ratio of exports to total domestic production hit a peak in 1984 at 26.5 percent for the processing and assembly sector and 36.4 percent for manufacturing. MITI expects the ratio to decline but still forecasts that overseas demand will absorb more than 20 percent of output at the end of this century. Confusing the picture are positive signs, such as higher domestic sales of cars versus exports for the first time in many years.

Table 5: Japan's Export Dependency Ratio*

(in percent)

<u>Year</u>	<u>Manufacturing</u>	<u>Processing and Assembly</u>
1975	31.8%	22.7%
1980	35.6	24.7
1984	36.4	26.5
1990 projected	34.5	24.7
1995 projected	29.2	21.1

*Ratio of total exports to total production.

Source: Ministry of International Trade and Industry

Some sign of change also is apparent from an aggregate viewpoint (Table 6). There was a natural downward trend in the secondary sector's (mining, construction and manufacturing) share of gross national product and a rise

in the tertiary sector's (such as finance, services, transportation) as Japan evolved from an industrial to post-industrial economy. In 1986, however, the secondary sector dropped sharply to 30 percent of the economy's output from 36.2 percent in 1985 due to the shrinkage of the manufacturing sector to 21.6 percent from 28.7 percent.

Table 6: Japan's Gross National Product by Sector*

(in percent)

Year	Primary	Secondary	Of Which:		Tertiary
			Manufacturing	Other	
1970	5.9%	43.2%	34.9%	8.3%	50.9%
1975	5.3	38.8	29.1	9.7	55.9
1980	3.6	37.7	28.2	9.5	58.7
1985	3.0	36.2	28.7	7.5	60.8
1986	3.1	30.0	21.6	8.4	66.9

*Nominal GNP

Source: Economic Planning Agency

The export psychology has proved very resistant to change, however. For three years in a row, a majority of Japan's non-financial companies responding to an Economic Planning Agency survey said they planned to maintain or increase exports. Corporate profit projections for FY 1988 and coming fiscal years indicate that exporters have adjusted to the stronger yen. According to a June 28, 1988 Nihon Keizai Shimbun survey, export-dependent firms expect solid profit growth next year if the yen remains at the ¥130=\$1.00 level. Most domestically oriented firms, in contrast, expect only modest gains under the same conditions. Ironically, MITI data show that exports have declined in profitability in comparison to domestic activities.

Japanese firms have begun to diversify. A recent Japan Fair Trade Commission survey shows that the ratio of original lines of business to total sales has declined in many industries since 1979. The survey does not show, however, whether the diversification has been oriented toward domestic or foreign demand.

It also is unclear if Japanese firms have stopped "pursuing market share at all costs," as the Maekawa report proposed. The number of dumping complaints filed against Japanese exporters in the United States has gone up somewhat in the last year or so as firms have tried to hold the line on price increases in the face of the yen's appreciation. Japan's integrated circuit makers certainly seem chastened by their experience with American complaints that they were buying U.S. market share in memory chips in the mid-1980s, and they have restrained their production competition for the current generation of chips. Moreover, after eight years of "voluntary" restraints, Japanese car makers are also more sensitive to the impact of exports and are making an increased commitment to overseas local production.

Deregulation has certainly become part of Japan's economic policies, although the Maekawa commission cannot take all the credit. In fact, Mr. Nakasone, when he was prime minister, had appointed another panel to focus on "administrative reform" of the government -- an idea that centers on privatizing major public enterprises, specifically Nippon Telegraph and Telephone, the Japanese National Railways and Japan Tobacco and Salt. In the cases of NTT and JTS, privatizing the public monopolies meant deregulating the domestic market and opening it to foreign as well as domestic competition. Although implementation hit some rough spots as the United States pressed to assure equal opportunities for foreign companies, the liberalization of the domestic telecommunications and tobacco markets has yielded benefits to all sides. Consumers now have a much greater choice of products at generally lower prices; foreign firms have been able to export more to Japan; and domestic companies have diversified to take advantage of new opportunities or availed themselves of new products and services.

International harmony - Encouraging the "international division of labor" entails several shifts. First, analysts agree, Japan must stop producing goods where it has lost comparative advantage. Japan's coal industry, for example, is scheduled to be phased out in a few years. Downsizing of other industries, such as aluminum and petroleum refining, is also being encouraged, a process that may be affected by the June 1988 expiration of the depressed industries law (see JEI Report No. 30B, August 5, 1988).

In turn, Japanese investment in overseas production facilities establishes subsidiaries and ties that encourage more imports, which can substitute for domestic goods, and aids in global growth. The government has not had to lift a finger to encourage firms to increase direct investment abroad. The latest figures from the Finance Ministry indicate that offshore investment grew 49.5 percent in FY 1987 (see JEI Report No. 23B, June 17, 1988). In addition, while investment in overseas manufacturing facilities fell in FY 1985 and FY 1986, it rose to 23.5 percent of all foreign direct investment in FY 1987. Most economists predict that foreign direct investment will continue to expand at a healthy clip as Japan restructures.

Tokyo also has actively supported the Multilateral Investment Guarantee Agency as recommended by the Maekawa report. MIGA was established by members of the World Bank to issue guarantees against non-commercial risks to participants that invest in member developing countries (see JEI Report No. 22B, June 12, 1987).

To ease the way for foreign investors in Japan, regulations governing foreign investment have been liberalized and sources of investment information and insurance improved. Ministry of Finance approval of almost all foreign investments is automatic, and foreign ownership in previously sensitive industries is allowed. Prefectural governments are trying hard to attract foreign investment, mounting promotion missions overseas and providing incentives and guidance.

As for importing more agricultural commodities, the process of liberalization is moving ahead. This past June Tokyo agreed to free imports of beef, oranges and orange juice by the early 1990s (see JEI Report No. 24B, June 24, 1988). A month later it agreed to phase out the quotas on seven categories of processed foods (see JEI Report No. 29B, July 29, 1988). These arrangements leave rice as the only important agricultural commodity not targeted for liberalization at the present time.

In terms of the price of food in Japan, the rate of progress leaves something to be desired. Aside from rice, beef and a short list of other products, however, there is little the government can do directly to lower food prices since these prices are heavily influenced by the cost of distribution (which will be discussed later). Inspection requirements and health standards can modestly influence the price of some products, particularly imported ones. Tokyo has not completely eased these regulations to benefit food imports or Japanese consumers.

Increasing foreign access to Japan's markets - Over the past 30 months Tokyo has moved to reduce tariffs and streamline standards and certification procedures to promote imports in general and manufactured imports in particular. Tokyo's July 1985 "action program" and the deregulation of telecommunications and tobacco markets have addressed these points to varying degrees. As shown in Table 7, the ratio of imports to GNP began growing even before the Maekawa report. Balance of payments statistics and customs clearance data both show that the value and the volume of imports have been recording healthy increases. MITI surveys report that imported goods are taking a greater share of the space in warehouses and on retailers' shelves (rising from around 10 percent in FY 1983 through FY 1985 to 13 percent in FY 1987). Manufactured products now account for close to 50 percent of total imports. This trend is likely to continue given the interest by domestic corporations in importing

Table 7: Ratio of Exports and Imports to GNP, 1966-88

(in percent)

<u>Year</u>	<u>Exports</u>	<u>Imports</u>
1966	7.6%	12.0%
1967	7.3	12.4
1968	7.9	13.3
1969	8.5	13.4
1970	9.1	14.9
1971	10.1	15.1
1972	9.9	15.3
1973	9.8	17.6
1974	12.2	18.9
1975	12.0	16.6
1976	13.2	16.7
1977	13.9	16.4
1978	13.1	16.4
1979	13.2	17.6
1980	14.9	15.9
1981	16.6	16.1
1982	16.7	15.9
1983	16.8	14.6
1984	18.8	15.4
1985	18.9	14.7
1986	17.6	14.9
1987	17.4	15.4
1988:I	17.6	16.4
1988:II	17.1	17.4

Source: Ministry of International Trade and Industry

items from their own overseas subsidiaries. Yet, although Japan's import performance has improved, it still has a way to go to match the manufactured import ratio of the United States or West Germany (see JEI Report No. 14A, April 8, 1988).

In contrast, actions to simplify the distribution system and to pursue antimonopoly policies more diligently are at the initial stage. As far as the distribution system is concerned, many in Japan do not feel it is a problem. They admit the system is complex and costly, but it certainly works. MITI, however, has begun discussions with the private sector on reforming laws that restrict the growth of large retail stores. MITI also is investigating how to help foreign firms penetrate Japan's distribution system.

Antimonopoly policy has always been a poor stepchild to MITI's industrial development programs. In light of the growing emphasis on consumer rights and concerns, however, the Fair Trade Commission can be expected to play a more vigorous role. Awareness of how domestic oligopolies have influenced prices is growing among Japanese consumers as low-price imports become increasingly available. For some products, such as film and small electronic items, discounting has become generally accepted. It may not be too long before "manufacturer's suggested retail price" takes on the same relevance in Japan as it does here -- a standard to measure bargains against.

Stabilizing exchange rates and liberalizing capital markets - International policy coordination has achieved orderly adjustments of exchange rates. The September 1985 agreement of the Group of Seven industrialized nations tempered exchange market volatility in 1986 and 1987 as the yen sought new levels against the dollar and other major currencies. As for helping stabilize exchange rates by the "elimination of major disparities in the economic performance of leading industrialized countries," Tokyo cannot be accused of shirking its duty. Spending on public works projects has been raised, and the public sector has made positive contributions to overall economic growth when it was called for.

On pursuing a financial role "commensurate with its economic importance," Tokyo also can claim many achievements. The catalyst for financial reform was the May 1984 yen-dollar accord. This agreement committed Japan to deregulate important interest rates, provide greater foreign access to its equity markets, reduce restrictions on the financial activities of Japanese corporations and develop new markets. By the time the first Maekawa report was released, diversification of financial instruments was well under way. Preparations also were being considered for new markets, such as the bankers' acceptance market, an offshore banking market, a market for commercial paper and financial futures trading. Tokyo's efforts to develop secondary markets, particularly for government bonds and notes, have been less successful. Residual restrictions and other institutional factors have hindered their expansion.

After several years of incremental changes, Japan's financial markets have clearly come a long way from their structure at the start of the decade. The number of foreign financial firms operating in Japan has at least tripled and continues to grow. Japanese banks and securities companies have quickly made their presence felt on markets around the world. There is no doubt that much remains to be done, but the country is so far down the road to deregulation that it is impossible to turn back. (See JEI Report No. 6A, February 12, 1988, and JEI Report No. 35B, September 16, 1988, for details of Japan's recent financial reforms.)

Promoting international cooperation - In this area, too, Japan has come through on most of the Maekawa recommendations. Japan has taken a bigger role in aiding developing countries, particularly through increasing contributions to multilateral organizations such as the International Monetary Fund, the World Bank and the Asian Development Bank. In addition, it has drastically increased its official development assistance to the point where Japan's aid budget for the current fiscal year is larger than the United States'. Japan's contribution will continue to grow. The third ODA doubling plan now in effect commits Japan to pour \$50 billion into development assistance over the 1988-92 period.

Solving the Third World debt problem also has occupied government planners. The Miyazawa Plan, described at a late September IMF meeting (see JEI Report No. 38B, October 7, 1988), represents an original proposal by the Japanese, although it is designed to complement the Baker Plan supported by the United States. However, the initiative remains in the initial discussion stage.

Tokyo also is actively supporting the current round of multilateral trade negotiations. Although it certainly has differences with the United States and the European nations, particularly on agricultural trade, the three are in general agreement on the expansion of GATT coverage to intellectual property and financial and services trades. Tokyo also is positioning itself to play the role of mediator between Western industrialized countries and developing nations, particularly those from Asia.

Moreover, Japan is expanding its contributions in the areas of science and culture. Cultural exchanges always have been an integral part of Japan's foreign policy, but funding has sometimes been lacking. Japanese corporations, organizations and even private citizens are now sponsoring cultural programs overseas. In the United States, subsidiaries of Japanese firms have slowly realized that more is expected of them than just providing goods and services; they are beginning to contribute to the social and cultural life of local communities.

On the scientific side, Japan is trying to repay its research debt to Western countries, particularly the United States, by sponsoring projects such as the Human Frontier program, which funds foreign research on basic biological questions. Tokyo also has tried to interest foreign companies in joint public-private research projects in superconductivity, optoelectronics and other areas. The main barrier to more foreign researchers in Japan seems to be the high cost of living there. Tokyo is unwilling to spend its scarce budget resources on subsidies. On the other hand, Japan continues to act as a rich source of technology for developing countries, especially in Asia. Government and corporate efforts to widen the flow to include Africa and South America have just begun and should show results within a few years.

Pursuing flexible fiscal and monetary policies - Tokyo has done surprisingly well in adhering to the overtly contradictory Maekawa ideas to "end its dependency on deficit financing bonds" while stimulating domestic demand. Budget figures for the past several years show that the government has held down the growth of discretionary spending but rearranged budget allocations to raise public works expenditures. (See JEI Report No. 18A, May 6, 1988 for a detailed breakdown of Japan's central government spending.) Spending priorities of the Fiscal Investment and Loan Program, a separate capital budget, also have been reordered to emphasize domestic stimulation. Although the debate over the

wisdom of eliminating government borrowing to cover current expenditures continues to rage, Tokyo appears to be set on this course for at least the next few years.

In terms of tax reform, Japan's record is spotty. Personal income taxes were cut for 1987 and 1988, but the ruling Liberal Democratic Party has been stymied in its efforts to win Diet approval for wide-ranging reform. All debates accept the Maekawa principles of equity, fairness and simplicity, but consensus evaporates when it comes to actual measures to achieve these goals. The government's only success according to the Maekawa criteria is the abolition of the maruyu system of incentives for saving. These tax-exempt accounts for small savers were abolished April 1 of this year. The impact on the personal savings rate appears to have been zero. In fact, by forcing savers to become more conscious of interest rates and other investment options, the change may end up increasing the excess funds generated by the household sector.

The Liberal Democratic Party introduced major tax reform legislation during the 1987 and 1988 Diet sessions. Both times, opposition parties were able to prevent passage by stalling and using obstructionist tactics as well as whipping up anti-tax sentiment among voters. Undaunted, Prime Minister Noboru Takeshita opened a special Diet session in July for the express purpose of adopting tax reforms in the face of major political obstacles. The package under consideration would substitute a 3 percent general consumption tax for many current commodity taxes, reduce levies on alcoholic beverages, tax capital gains more heavily and cut inheritance taxes -- all steps aimed at improving the fairness of the tax system (see JEI Report No. 24B, June 24, 1988). While chances are good that Mr. Takeshita will win approval by the end of November (see JEI Report No. 37B, September 30, 1988), the changes represent only the first step in fulfilling the Maekawa vision.

Meeting the ultimate goal - Has Japan succeeded in expanding domestic demand to reduce its dependence on exports? Yes and no. Clearly the net external sector has been a drag on the economy since the beginning of 1986, leaving domestic demand to power the economy (Table 3). Trade, however, continues to represent a good chunk of Japan's economic activity. Exports as a percentage of GNP, for example, have only fallen from 18.9 percent in 1985 to 17.1 percent in the second quarter of 1988 (Table 7). From this and corporate business plans, it appears that Japanese exporters do not plan to reduce exports, at least in value terms.

Has the standard of living improved? It is too early to tell. Although the Japanese enjoy consumer appliances and electronic luxuries to a similar degree as citizens in Western industrialized nations, Japan's stock of social capital (parks, roads, and sewers, for example) is far smaller than its peers' (see Table 8). In other respects, the average Japanese is beginning to enjoy leisure activities to a greater degree than before, particularly foreign travel. The high number of working hours, however, remains a problem.

Tokyo's adherence to the general principles of the Maekawa reports has been generally good, even if the pace of change seems glacial in some cases. Certainly in the area of financial market liberalization, greater use of open market forces has become the buzzword. As for a global perspective, the Japanese are still grappling with the concept. Kokusaika or "internationalization" is the latest thing in corporate and personal outlooks. Ask the average Japanese what this means, however, and you will get vague or contradictory answers. Insularity and ethnocentrism lie very close to the center of Japanese self

perception -- the group orientation of society ensures that there is always an "us-them" distinction. This does not mean that Japan is insincere about its international responsibilities or that it will not bear them in good faith. It does probably mean that Japan will pursue these goals in ways different from the United States. There is almost universal Japanese agreement that the process of restructuring and adjustment is a long-term project. The conflict comes in deciding what immediate steps to take.

Table 8: International Comparison of Social Capital

	<u>Japan</u>	<u>United States</u>	<u>Great Britain</u>	<u>West Germany</u>	<u>France</u>
Consumer Durable Goods Index	124.3	135.5	100.2	97.9	66.4
Social Capital Index	40.6	101.8	111.7	112.8	73.7
Paved Roads (percent)	57.7 (1985)	85.0 (1981)	100.0 (1984)	99.0 (1983)	95.1 (1984)
Sewers (percent)	36.0 (1986)	72.0 (1979)	97.0 (1976)	91.0 (1983)	65.0 (1975)
Per Capita Urban Parks (square meters)	2.2 (1985)	21.5 (1984)	30.4 (1976)	37.4 (1984)	12.2 (1984)

Notes:

1. Consumer durable goods index includes refrigerators, freezers, electric washing machines, color television sets, videocassette recorders, microwave ovens, pianos and stereo equipment per household. The average of the European nations and the United States is equal to 100.

Source: Leisure Development Center, 13 Nations' Sense of Values Survey Data Book (1980).

2. Social capital index represents the percent of the population with sewer service, park area per person, length of highways per 100,000 vehicles, and the average number of people per room of a house. The average of the European nations and the United States is equal to 100.

Source: United Nations, I.R.F. Annual Statistics Report, 1986, Annual Bulletin of Housing and Building Statistics for Europe, and Annual World Statistics Report.

3. Paved roads show the percent of total roads with simple paving.
4. Sewers indicate the percent of total households connected to a sewer system.
5. Per capita urban park is based on Tokyo for Japan, Los Angeles for the United States, London for Britain, the national average for West Germany and Paris for France.

Source: Ministry of Construction

The Best is Yet to Come

It is clear that Japan has achieved much of what the Maekawa commission recommended. It also is clear that just as much remains to be done. The next tasks will be more difficult to achieve since they require a good deal of time or great political will to solve. Problems that can be solved only over time include raising the social capital stock, dealing with the Third World debt problem, increasing Japan's contribution to science and technology, and restructuring the domestic market to focus on domestic demand. None of these is overly difficult, just time consuming. The question is whether the world can wait for Japan to take the necessary actions. Particularly with regard to economic restructuring, it is not at all certain that the current global economic system can withstand the strain of persistently large current account imbalances.

Other problems, such as land use reform, agricultural reform and macroeconomic coordination, are in a different class. These problems can lead to wrenching changes in the social, the political and the economic life of Japan. Land use and agricultural reform are especially sensitive issues, resembling a Gordian knot. More rational use of Japan's limited land resources would ease the housing situation, reduce the barriers to agricultural reform and probably lead to an increase in the standard of living. Strong political leadership will be needed to weld a domestic consensus on how to achieve these goals. Similarly, attaining true macroeconomic coordination requires an attitude of concern for global matters that is not present even in such an internationally minded country as the United States. This goal may never be attained -- and some would argue that this is a positive limitation.

Finally, it is not certain that the basic underlying goal of the Maekawa reports -- to change the perceptions of Japan's global role at the grass-roots level -- can be achieved any time soon. Without such a change, Japan's commitment to international growth and harmony may be perceived cynically abroad as an exercise in expanding influence. As any American politician who has tried to interest the average citizen in foreign policy knows, it is difficult to get people to widen the scope of their concerns beyond personal boundaries. To sustain such a broader interest at the national level is even more difficult. Nevertheless, there are already signs that some concepts, such as Japan's responsibilities as an economic power to aid developing countries, are taking hold in the popular mind. Even if the Maekawa reports are never fully implemented, they will be a success if they contribute to a broadened Japanese mindset.

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The views expressed in this report are those of the author and do not necessarily represent those of the Japan Economic Institute.

The First "Maekawa" Report

The Report of the Advisory Group on Economic Structural Adjustment for International Harmony

April 7, 1986

This Advisory Group was requested by the Prime Minister on October 31, 1985, to conduct a study on policy measures from medium- and long-term perspectives concerning Japan's economic and social structure and management in response to the recent environmental changes surrounding Japan in the international economic situation.

Accordingly, the group has met 19 times during the last five months to hold free discussions among its members. Following is the report on the result of those discussions.

I. Background

1. The Japanese Economy Today

Having achieved very rapid economic growth in the forty years since the end of the war, Japan today occupies an important position within the international community. Japan's international balance-of-payments has tended to show increasing current account surpluses in the 1980s. In 1985 in particular, this surplus was unprecedentedly large, i.e., 3.6 percent of GNP. It is imperative that we recognize that continued large current account imbalances create a critical situation not only for the management of the Japanese economy, but also for the harmonious development of the world economy. The time has come for Japan to make a historical transformation in its traditional policies on economic management and the nation's life-style. There can be no further development for Japan without this transformation.

2. A National Goal for Japan

Setting as a medium-term national goal, the government should announce its determination both domestically and internationally to attain the goal of steadily reducing the nation's current account imbalance to one consistent with international harmony. The large current account surplus is basically linked with Japan's economic structure, which is export-oriented. And there is an urgent need for Japan to implement drastic policies for structural adjustment and to seek to transform the Japanese economic structure into one oriented toward international coordination.

The process of achieving this goal should also entail efforts to enhance the quality of the nation's living standard; it is imperative for us to realize that our success in achieving this goal will be essential in determining Japan's future in the international community. In all of this, Japan should undertake responsibilities commensurate with its economic position and strive for harmonious co-existence within the world economy, as well as working to contribute to the world community not only economically but also in the scientific and technological, cultural and academic fields.

This group, in order to accomplish a number of specific steps that the government should take in keeping with the following principles for the attainment of this goal.

3. Principles

In making these recommendations, we have kept in mind the need to achieve these policy goals through balanced economic growth and the resultant import expansion to maintain and strengthen the free trade system and to work for sustained and stable world economic growth.

(1) Policies Based Upon Market Principles

In order to make Japan more internationally open, policies based upon market mechanisms should be implemented from the view point of "freedom in principle, restrictions only as exceptions." Accordingly, further improvement in market access and thorough promotion of deregulation should be carried out.

(2) Policies From A Global Perspective

Believing that the Japanese economy can only develop within a context of sustained and stable growth of the world economy, we find it imperative that Japan rectify its economic structure on its own initiative. At the same time, we believe that world economic growth requires efforts and cooperation of all countries, and policy coordination must be achieved in structural adjustment and other fields.

(3) Continued Long-Term Efforts

Since the process of reforming the economic structure and improving the basic character of our economy is a long-term one, efforts to this end should be made continuously and from a long-term perspective. However, relevant policy must be initiated as soon as possible.

II. Recommendations

In seeking to orient the economy toward international harmony and to make Japan an international state, it is imperative that -- along with striving for economic growth led by domestic demand -- the government promote basic transformations in the nation's trade and industrial structure. At the same time, the government must work for the realization and stabilization of the exchange rate at an appropriate level and must further promote the liberalization and internationalization of the nation's financial and capital markets. Furthermore, it is important for Japan to contribute actively to the well-being of the world community through international cooperation. In the implementation of these recommendations, fiscal and monetary policy -- including taxation -- also have a significant part to play. Especially, the preferential tax treatments for saving should be fundamentally reviewed.

1. Expanding Domestic Demand

Promoting the transformation from export-led economic growth to that driven by domestic demand requires that the government put firmly into place domestic demand expansion policies that have large multiplier effects and will lead to increased private consumption.

(1) Promoting Housing Policies and Urban Development

Efforts should be made toward a fundamental reform in Japanese housing policy; strengthening and broadening of measures to promote housing is required. In large urban centers in particular, creation of new residential areas closer to offices by redeveloping existing areas and construction of new residential neighborhoods are to be promoted. Also, urban facilities are to be expanded and improved. There are a number of points which should be kept in mind in carrying out these efforts:

A. The scale of such projects is to be expanded centering on the mobilization of private-sector vitality. Steps must, therefore, be taken to ease regulations and to provide pump-priming financial incentives.

B. Tax deductions should be expanded for acquisition of houses.

C. Measures should be taken to keep land prices stabilized, e.g., re-zoning of urban areas, relaxing local government residential development guidelines, and easing the restrictions on building size and land use.

D. Efforts should be made to accelerate the settlement of problems arising from land use among those concerned.

(2) Stimulating Private Consumption

Along with the appropriate distribution of economic growth in wages, tax cuts increasing disposable income are effective in expanding private consumption. People should have more free time through reduced working hours, and the active use of paid leaves for longer periods should be encouraged. The total working hours per year in line with the industrialized countries of Europe and North America and early realization of complete five-day work weeks should be pursued in the private sector, while efforts should be made for speedy implementation of these policies in the public and financial sectors.

(3) Promoting Social Infrastructure Investment by Local Government

A radical increase in the capital formation by local governments is essential to spreading nationwide the impact of stronger demand. Accordingly, in order to promote infrastructure developments, local independent works should be enlarged by making use of local government loans.

2. Transformation to an International Harmonious Industrial Structure

The shift to an internationally harmonious trade and industrial structure should basically be pursued through market mechanisms, but additional efforts should also be made through the following measures:

(1) Promoting Transformation of Industrial Structure and Positive Industrial Adjustment

Positive industrial adjustment must be promoted to encourage the international division of labor. To this end, it is necessary while paying due consideration to the impact on small- and medium-sized businesses, to promote actively the transformation of the nation's industrial structure. In this connection, the structural reforms now being promoted under current laws should be accelerated. Taking account of the serious impact on local economies, fiscal policy should be reviewed with a view to lowering the level of domestic output drastically and increasing imports. Also, in promoting industrial restructuring, it is important to encourage technological research and development, the growing diffusion and application of information technology in the economy and society and the development of the service sector accelerated by the greater availability of free time and diversification of consumption patterns.

(2) Promoting Direct Investment

Direct overseas investment plays an important role in rectifying Japan's external economic imbalances and in promoting the host country's economic development. Overseas investment has been expanding rapidly in recent years and, with due consideration to the impact on domestic employment and the economy, this should be further encouraged. Accordingly, conclusion of bilateral agreements concerning protection of investment should be encouraged, overseas investment insurance schemes should be improved, and participation in multilateral investment guarantee agency (MIGA) should be undertaken and other governmental measures to support overseas investment should be reinforced. It is also necessary to expand economic cooperation to improve the environment for investment in the developing countries.

Foreign investment in Japan should also be encouraged with improved conditions for financial assistance, increased supply of information, and other measures. Furthermore, industrial cooperation should be actively promoted including technology exchange and cooperation in third-country markets, especially the setting up of a private-sector-led institution for industrial cooperation for the purpose of enhancing personnel exchanges should be encouraged.

(3) Promoting Agricultural Policies Befitting to an Age of Internationalization

In order to achieve maximum productivity with and conditions and other constraints, the government should have a clear perspective for Japan's agriculture in the future. To this end, the government should work to achieve a thorough structural improvement, thereby promoting agricultural policies befitting an 'age of internationalization.' In so doing, priorities should be given to the policies focused on fostering core farmers for the future, and price policies should be reviewed and rationalized toward greater use of market mechanisms and active promotion of structural policies.

With the exception of basic farm products, efforts should be made toward a steady increase in imports of products (including agricultural processed products) whose domestic prices and the international market prices differ markedly. These price disparities should be reduced while agriculture should be rationalized and made more efficient.

with regard to products subject to quantitative import restrictions, efforts should be made to improve market access under the future perspective for making the Japanese market more open while taking account of developments in the relevant consultations and negotiations including the GATT New Round.

3. Further Improving Market Access and Encouraging Imports of Manufactured Goods

(1) Further Improving Market Access

Full implementation of the Action Program for Improved Market Access should be promoted in the areas of tariffs, import restriction, standards and certification, and government procurement and so on. Also, the Office of Trade and Investment Ombudsman (O.T.O.) should be reinforced including the study of the possibility of giving a legal basis to it in order to further improve market access.

(2) Encouraging Imports of Manufactured Goods

Further active efforts should be made to encourage imports of manufactured goods together with steady implementation of various structural measures, including overseas investment which will contribute to the international division of labor such as local production and expanded imports of semi-finished and finished products. Together with promoting the streamlining of distribution mechanisms and conducting review of the various restrictions pertaining to distribution and sales, efforts should also be made to ensure the strict enforcement of the antimonopoly law for the prevention of unfair business transactions and to strengthen domestic arrangements to eliminate illegal acts with regard to foreign trademarks and counterfeit products.

This should be done with special attention to monitoring the registration of international contracts dealing harshly with unfair or exclusive trading practices and checking that nothing is done to unfairly prevent parallel imports. Along with seeking to expand import promotion policies through intensifying consumer-directed import promotion campaigns and ensuring the complete availability abroad of information on the Japanese market and distribution systems, efforts should be made to promote expanded economic cooperation and private-sector technology transfers to contribute to expanded imports of manufactured goods from developing countries.

(3) Prudent Behavior of Private Companies

Considering the strong possibility of frictions caused by the behavior of private companies which tend to pursue expanded market share at all cost, it is hoped that Japanese companies will behave in awareness of their international responsibilities.

4. Stabilization of Exchange Rates and Liberalization and Internationalization of Financial and Capital Markets

(1) Stabilizing and Sustaining Appropriate Exchange Rates

In achieving a proper balance between domestic and external demands it is essential that exchange rates be stable and in line with economic fundamentals. While the government needs to place emphasis on exchange rate stability in its policy management, this goal cannot be achieved by Japanese policy efforts alone and international efforts are needed.

Under the present circumstances, arrangements for stability must be considered within the framework of floating exchange rates and elimination of major disparities in the economic performance of the leading industrialized countries is the underlying basis of exchange rate stability. There is, therefore, a clear need for a high level of policy coordination among these countries. However, since there is no guarantee that exchange rates will always reflect the fundamentals, cooperation and intervention by the countries concerned can be effective tools for correction.

While ensuring international compatibility of basic economic policy, it is important that efforts be made to build upon the accumulated experiences of international cooperation in developing a framework for future stability.

(2) Liberalization of Financial and Capital Markets and Internationalization of the Yen

With the liberalization of financial and capital transactions, transactions now take place on a global scale and Japan should ensure that its financial and capital markets are commensurate with its economic importance. This will also facilitate the internationalization of the yen. Thus efforts should be made to further liberalize financial and capital transactions and to expand transactions by nonresidents both for financing and for investment.

Internationalization in the latter respect has been relatively slow in Japan. It is now essential to develop market facilities for funds from abroad so as to achieve a better balance between financing and investment.

Strengthening Investment Markets

8. There is a need to diversify investment instruments and particularly the development of short-term financial markets is an urgent task.

9. The expansion and strengthening of secondary markets and the internationalization of trading requires international compatibility of market arrangements and trading practices in particular. With respect to taxation with due attention to the international point of view.

5. Promotion of International Cooperation and Japan's Contribution to the World Economy Commensurate with its International Status

The following policies should be implemented to promote international cooperation and to contribute to the world economy while appropriate measures on necessary financial resources should be taken.

(1) Promotion of International Cooperation

A. Expanding Imports from Developing Countries

Efforts should be made to encourage imports of manufactured goods from developing countries through such means as technology transfer and expanded investment from Japan which will contribute to promoting improvements in the export industries of developing countries and further cooperation with their market penetration efforts.

B. Alleviation of the Debt Problem

Japan should work in cooperation with other leading industrialized countries to promote efforts for lower interest rates, to increase the official financial flow to developing countries, to strengthen the financial basis of multilateral development banks as well as to further improve their efficiency, and to give consideration to the impact of the debt problem of developing countries on private financial institutions.

C. Promoting Economic and Technical Cooperation

Every effort should be made to achieve as early as possible the current medium-term target to expand Japan's Official Development Assistance (ODA). It is also important that the non-government organizations (NGOs) be mobilized in this effort. As for the contents of economic and technical cooperation, it is necessary to expand technical assistance, place emphasis on training of assistance personnel, improve the grant element, restrain mixed credits, and promote untied aid.

D. Promoting International Exchanges in the Fields of Science and Technology and Culture

Japan should actively contribute to the creation of new science and technology for the twenty-first century as well as promote research and development in basic science and technology. Japan should promote international research cooperation in these fields.

Efforts should be made to promote Japanese language education and Japanese studies overseas to support personnel exchanges and to strengthen international broadcasting. Efforts must also be made to adapt to the age of internationalization such as by opening doors of academic and research institutions to foreigners, arranging to accept more foreign teachers and students, and to accommodate Japanese students returning from overseas.

(2) Active Promotion of the GATT New Round

While responding positively to the matters of interest to developing countries, the government should actively participate in the establishment of international rules in such new fields as trade in services and intellectual property rights. The government should also seek to improve the GATT rules and strengthen the GATT system in order to restore the credibility of the GATT. It is hoped that the government will actively conduct negotiations on tariffs in accordance with the decision in the Action Program with regard to tariffs of industrial products.

6. On Fiscal and Monetary Policy Management

In the implementation of these recommendations, fiscal and monetary policies have a significant part to play. In implementing fiscal policy, it is necessary to maintain the basic policy stance of fiscal reform to end its dependency on deficit-financing bonds and also to respond flexibly in an effort to achieve economic and social balance on a medium- and long-term basis with creative efforts for the appropriation of fiscal resources with effectiveness and priority for the mobilization of private-sector vitality and for deregulation.

The tax system should be reviewed from the perspectives of equity, fairness, simplicity, economic vitality, and choice as well as from an international point of view. The preferential tax treatment for savings, in particular, should be fundamentally reviewed in light of these principles, including abolition of the tax exemption of interest on small amount savings.

While ensuring stability, flexible management of monetary policy is necessary in relation to economic and domestic demand.

7. Follow-Up

The group strongly hopes that the government will make necessary examinations on these recommendations in order to make possible and take necessary measures for their implementation. The group further hopes that necessary arrangements will be made so that appropriate follow-up will be done for the implementation of these measures.

III. Conclusion

The government obviously has a very important role to play in transforming Japan's social and economic structure for greater harmony with the international community. But each and every Japanese should also be fully aware that Japan cannot develop unless it also contributes actively to the international community. It is imperative that every effort be made for attainment of this national goal.

The group thus very much hopes that the government will make every effort to implement these recommendations with the full understanding and support of the entire nation.

The Second "Maekawa" Report

Summary Report of the Economic Council's Special Committee
on Economic Restructuring

April 23, 1987

Introduction

Japan is today posting large current account surpluses, and there are signs of intensifying economic friction with other countries. This imbalance cannot be allowed to continue, either for the Japanese economy itself or for the harmonious development of the world economy. This situation having arisen in an interdependent world economy, Japanese policy responses alone cannot rectify this imbalance. International policy coordination is also needed, including reductions in the United States fiscal deficit. Nevertheless, as a country largely dependent upon free trade, a country accounting for one-tenth of the world GNP, and the world's largest creditor nation, Japan must take the initiative in rolling back protectionism and defending the free trade system by seeking to achieve an internationally harmonious external balance and to make a positive contribution to the international community.

Looking inward, it is questionable whether or not Japan's economic growth is reflected in the quality of Japanese life: housing standards are low, the cost of living high, and working hours long. With the yen's recent appreciation, a yawning gap has developed between our personal perceptions of the yen's value in everyday life and its value on exchange markets. The people have thus begun to wonder whether the yen's strength is reflected in their own standard of living. As the yen has appreciated since September 1985, this has generated friction in a number of areas and this friction has in turn given rise to popular anxiety about Japan's economic future. The promotion of economic restructuring must be premised upon popular understanding that this restructuring will contribute to the quality of their lives.

Since the announcement of the Report of the Advisory Group on Economic Restructuring for the International Harmony in April 1985, the government has sought to flush out the specifics of the Report's recommendations. The government announced its Outline of Procedures for the Promotion of Economic Restructuring in May, and the Government-Ruling Party Joint Headquarters for the Promotion of Economic Restructuring was established, headed by the Prime Minister. As a result, specific policies are being formulated for revising the preferential tax treatment for savings, improving the tax treatment for housing acquisition, reducing legal limits on working hours, cutting back on domestic coal output, establishing an offshore financial market, and more. Efforts have also been made to respond with flexible fiscal and monetary policies under the Comprehensive Economic Measures and other initiatives. However, we have just begun on the long road to economic restructuring, and promoting economic restructuring which ensures both international harmony and better-quality Japanese living simultaneously is increasingly imperative and increasingly urgent.

Given this situation, this Committee was requested by the Economic Council on September 5, 1986, to conduct a study of the policies needed for medium- and long-term economic restructuring. Having held a total of 43 meetings since receiving its mandate eight months ago, the Committee is pleased to be able to present its final report. We call upon the government to work to steadily study and implement specific policies for the promotion of economic restructuring.

Chapter 1. Basic Approach to Restructuring

1. Economic restructuring is intended to simultaneously attain external harmony and domestic-demand-led economic growth. This will ultimately improve the quality of Japanese life.

2. In order to rectify the major multilateral imbalances, it is necessary to have policy coordination including reductions in the United States fiscal deficit and a rejoining of American industrial competitiveness. Japan should move forward on initiatives to achieving restructuring and domestic-demand-led economic growth. The period of the mid-1990s will be critical for restructuring efforts.

3. Japan should seek to reduce the current account surplus as a percentage of GNP as quickly as possible within this context of international policy coordination.

4. The process of economic restructuring should be based upon market mechanisms. Thus Japan should seek to promote foreign competition, revive its domestic industrial activity and for improved market access for imports. There is an urgent need for a thorough, separate review by new organization.

5. Effective monetary policy will be an important role to play in stimulating domestic demands. It is especially important that Japan's monetary resource redistributive functions be utilized. While observing the basic spirit of administrative and monetary reform and realizing the benefits of the progress made, extraordinary and urgent fiscal measures should be taken to stimulate domestic demand in light of the current economic situation. Efforts will continue to be made for appropriate fiscal and monetary policy management.

Chapter 2. Policies for Restructuring

A. Expansion of Domestic Demand

1. Housing

(1) The qualitative improving of housing is a mainstay of the effort to expand domestic demand, and policy resources should be allocated with a special priority on this field. Housing policy should be promoted with attention to economic policy considerations as well as social policy concerns.

(2) Instituting radically preferential tax treatment for housing acquisition and the like, an effort should also be made to further enhance and improve home financing and other incentives.

(3) On the supply side, there is a need to institute creative competition-promotion policies including encouraging more firms to enter the housing market.

2. Improving Social Capital

(1) Looking ahead to the twenty-first century, it is important that we work steadily and systematically to raise the quality of the Japanese social capital commensurate with Japan's international status.

(2) Achieving balanced enhancement of social capital demands that public and private sectors work with an appropriate sharing of financing and that the necessary public moneys be secured.

(3) In enhancing social capital, it is imperative that the tradition allocation be reassessed and priority allocation promoted.

(4) In drawing on private-sector vitality, it is important that dramatic incentives be provided.

3. Land Policy

(1) The enhancement of housing and social assets hinges upon finding a solution to the land problem.

(2) It is thus fundamentally important that efficient use be made of national land resources through promoting the broader dispersion of industrial and other facilities for balanced national development.

(3) Land policy issues are inexorably linked to urban policy issues, and it is imperative that reform of large cities be actively promoted via redevelopment of urban areas.

(4) An effort should be made to promote the conversion from agricultural to residential land by taxing agricultural land in urbanization promotion areas to more closely approximate the taxation of residential land.

(5) Efforts should be made to expand the supply of residential land with rezoning and an ambitious effort to landfill public waters.

4. Consumption

(1) There is a considerable gap between Japan's per-capita GNP and popular perceptions from everyday life. An effort will thus be made to reduce the differential between Japanese and international prices and hence to close this gap.

(2) The benefits of the yen's appreciation should be used to spur domestic demand. This is especially important in sectors subject to public regulation.

(3) Stimulating consumption basically demands a steady growth in real disposable income under conditions of sustained economic growth and price stability.

(4) Economic growth should be reflected in increased wage rates and shorter working hours.

II. Shorter Working Hours

(1) The shortening of working hours is important for enhancing national standards of living, for stimulating consumption, and for maintaining employment.

(2) An effort should be made to reduce Japanese working hours to about 1,800 hours per year as soon as possible and no later than the end of the century (as with five-day workweeks and 20 paid days off per year).

(3) It is important to ambitiously promote the five-day workweek by, for example, having government offices and financial institutions close on Saturdays.

III. Internationally Harmonious Industrial Structure

1. Efforts for Industrial Restructuring

(1) Industrial restructuring must be premised upon market mechanisms, and the government's response must not entail involvement in specific industries but must be restricted to easing the pain of restructuring.

(2) This process of industrial restructuring is a process of increasing industrial sophistication. While working to create a climate conducive to the full exercise of public and corporate vitality, we should facilitate this restructuring.

(3) Rather than see the present as a time of "hollowization" and seek to forestall it, we should push ahead with forward-looking responses.

2. Direct Overseas Investment

(1) Japanese direct overseas investment will contribute to increased horizontal division of labor and expand both production and employment in the host countries.

(2) This will also contribute to reducing Japan's current account surplus.

3. Enhancing Competitive Conditions

(1) In such fields as distribution, financial services, construction, agriculture, transportation, and telecommunications, it is necessary to work for greater efficiency and productivity through promoting far-reaching deregulation, further improved market access for import expansion, the use of investment in Japan, and other means.

(2) Some regulations in distribution have outlived their justification, and there is a need to fundamentally review the licensing regulations.

(3) Positive efforts should be made to ensure that foreign companies do business in the Japanese construction market.

(4) Efforts should be made to make the petroleum industry more rational and more efficient with step-by-step deregulation.

4. Expanding Imports and Improving Market Access

(1) Achieving an internationally harmonious import-export structure is prerequisite to rectifying the external imbalance.

(2) Further efforts should be made to reduce the number of products subject to the standards and certification systems, to reduce the number of standards themselves, and to promote improved market access.

(3) An effort should be made to promote the abolition of the tariffs on manufactures in the GATT Uruguay Round.

(4) An effort should be made to improve the government procurement system and to promote governmental imports of manufactured goods.

(5) Japan will take an active role in promoting the GATT Uruguay Round, including services, agricultural products, and other fields.

5. Agriculture Policies Reflecting an Era of Internationalization

(1) Efforts to promote agricultural policy must give full consideration not only to producers but also to consumers and the food industry.

(2) An effort should be made to reduce the differential between Japanese and overseas prices and to achieve stable foodstuff supplies at popularly acceptable prices by improving productivity and promoting imports as appropriate.

(3) Efforts should be made to expand operational scales and improve productivity for greater value-added production to establish agriculture as a viable industry.

(4) Responsive to the diversification of consumer requirements, efforts should be made to improve government controls so as to expand leading to independent-market rise, to introduce competitive principles in all stages from collecting to marketing.

(5) While seeking to make Japanese production more rational and more efficient, an effort should be made to hold border adjustment measures to a minimum for non-rise agricultural products.

6. Responses to Unemployment

(1) Employment is the most important issue in industrial restructuring.

(2) The process of industrial restructuring may well generate unemployment arising from the supply-demand imbalance among industries, occupations, age groups, geographic locations, etc. Comprehensive employment policies are needed to facilitate labor mobility and develop expanded employment opportunities.

(3) In the longer term, we should work to become a vigorous long-lived society through Japanese-style work-sharing involving shorter work hours and the redistribution of employment across generational and other lines.

7. Responses for Regional Economies

(1) It is imperative that structurally depressed regions receive priority allocation of public works projects to alleviate occupational changes and other pains of restructuring.

(2) Efforts should be made to promote the creation of employment and other regional employment policies through encouraging the shift to new industries.

3. In light of the fact that information- and service-oriented industries and other urban industries will be the mainstay of development, there is a need to promote the creation of attractive regional urban centers.

4. As part of this effort, information and telecommunications infrastructures should be improved, heliports and other high-speed transport network facilities created, and the amenities of life provided in full.

VI. Contributions to a Better World

1. Japan will make a positive effort to roll back protectionist pressures and to preserve and strengthen the existing free trade system by actively promoting the Uruguay Round.

2. It is imperative that Japan respond positively to resolving the problems of excessive external indebtedness within the framework of international cooperation, including responding to the debtor countries' capital needs and working to lighten their interest burden.

3. Every effort should be made to promptly attain the Medium-Term Target for Official Development Assistance (ODA) at an early stage so as to raise the ratio of ODA to GNP and to work for ODA's quantitative enhancement. Efforts will also be made to involve private-sector capital and personnel more in economic cooperation through a variety of means.

4. Japan will contribute actively to international cooperation in basic research and international public works projects.

5. Japan will work to revitalize and internationalize Japanese education with expanded acceptance of foreign educators and educational and research institutions.

Chapter 3. Immediate Action for Restructuring

Although restructuring is a long-term national goal, it is imperative that efforts be concentrated in the next few years to achieve restructuring in view of the existing situation in Japan and overseas. In this context, the following recommendations should be implemented immediately and the expected results achieved within a certain period.

I. Deregulation

1. Fundamental review of regulations by a new organization with a view to pursuing thorough economic deregulation in the domestic economy and market access.

2. Relaxation of regulations in distribution and finance sectors and in petroleum and other industries.

3. Positive efforts to ensure that foreign companies do business in Japan's construction market.

II. Active Use of Fiscal Policy

Implementation of extraordinary and urgent fiscal measures to cope with the current economic situation while observing the basic spirit of administrative and fiscal reform and reaping the benefits of the progress made.

III. Housing Policy, Land Policy, and Improving Social Capital

1. Priority allocation of public funds for housing.

2. Reform of large cities via redevelopment of urban areas, etc.

3. Promoting the conversion of land from agricultural to residential purposes by taxing agricultural land in urbanization promotion areas to more closely approximate the taxation of residential land, positively reviewing rezoning, and other means.

4. Improvement and expansion of the residential environment, the infrastructure in such areas as telecommunications and information, and high-speed transportation networks in regional urban centers.

5. Priority allocation of public works projects.

IV. Stepped-up Imports of Manufactured Goods

1. Promoting the abolition of tariffs on manufactured products in the GATT Uruguay Round.

2. Improving the government procurement system and promoting governmental imports of manufactured goods.

V. Agriculture

1. Reducing the differential between Japanese and overseas foodstuff prices by raising productivity and promoting imports.
2. Improving the existing food supply and demand system under government control by introducing competitive principles in all stages from collection to marketing.

VI. Shorter Working Hours

1. Moving to reduce total working hours to 1,800 per year.
2. Promotion of the five-day week for civil servants and personnel in financial institutions (including closing their offices on Saturdays).

VII. Economic Cooperation

Prompt attainment of the Medium-Term Target for ODA and raising the ratio of ODA to GNP (including advancing the target for doubling ODA from seven years by two years).

In promoting these policy measures, it is imperative that all due consideration be paid to the impact on employment and local economies.

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J A P A N · E C O N O M I C · I N S T I T U T E

JEI

R E P O R T

A Two-Part Report: A and B

NO. 39B
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New MOSS Talks?

The possibility of launching a new round of bilateral trade talks modeled on 1985's successful MOSS (market-oriented, sector-selective) negotiations was debated by U.S.-Japan experts September 27 on Capitol Hill. Although the testimony did not suggest specific sectors for the proposed MOSS talks, witnesses did promise to submit written recommendations at a later date. The original MOSS talks achieved more progress in certain areas than in others, but those who testified concurred that the approach was successful enough to warrant future negotiations -- but only if appropriate new sectors can be identified.

A joint hearing by the House Foreign Affairs Committee's panels on Asian and Pacific Affairs and International Economic Policy and Trade focused on the impact of negotiated market access in the second of four hearings on U.S.-Japan relations. The original MOSS talks, which were concluded in early 1986 (see JEI Report No. 2B, January 17, 1986), covered four sectors: telecommunications equipment and services, medical equipment and pharmaceuticals, electronics, and

Currency Market Intervention Diminishes

Last winter the Bank of Japan looked as if it were playing doctor to the hobbled dollar. The bank joined other central banks in the industrial world in administering support by buying dollars and selling other currencies, thereby driving up the price of the American currency. Japan ended up holding more dollars, swelling its foreign currency reserves.

The effectiveness of the action is unclear: the dollar fell anyway during some of the periods of heaviest intervention and ended 1987 at an all-time low. But three-quarters of the way through 1988, the patient seems to have recovered a little, and the doctors are reducing the prescribed medication. The increase in foreign currency reserves, one of several flawed measures of intervention, has been much smaller in recent months according to the Ministry of Finance (see Table), although Japan's reserves remain the world's largest. Using a slightly different yardstick than MOF's, the International Monetary Fund put Japan's July reserves at \$89.2 billion, ahead of West Germany's at \$65.7 billion. But Taiwan, not a member of IMF, had \$70.9 billion in reserves in June, probably enough to claim runner-up status to Japan.

Japan's Foreign Exchange Reserves

(in billions of dollars at end of each period)

	<u>Level</u>	<u>Change From Previous Period</u>
1982	\$23,262	\$-5,141
1983	24,496	1,234
1984	26,313	1,817
1985	26,510	197
1986	42,239	15,729
1987	81,479	39,240
1988		
January	83,407	1,928
February	83,821	414
March	84,857	1,036
April	86,838	1,981
May	87,244	406
June	87,700	456
July	88,908	1,208
August	90,222	1,314
September	91,151	929

Source: Ministry of Finance

A related measure of intervention also suggests that BOJ has been less active in 1988. For the first half of the fiscal year that began April 1, the Ministry of Finance calculated that net payments of foreign exchange funds to the public totalled ¥136.4 billion (\$1.1 billion at ¥125=\$1.00), a sharply slower pace than in the previous six months, in which the payments came to ¥1.3 trillion (\$10.4 billion). Most of these payments arise from intervention in the foreign currency markets.

The slowdown in currency intervention is consistent with data showing a rebound in private outbound capital flows. With private investors willing to put their money abroad, there is less need for official action. At a minimum, the doctors at the Bank of Japan have a chance to take a breather.

Douglas Ostrom

Data Bases Build In Japan

Japan's data base market has expanded significantly since JEI first reported on its status (see JEI Report No. 26B, July 18, 1986), in large part due to an explosion of foreign products available in Japan. According to the Ministry of International Trade and Industry, the number of data bases available in Japan rose a strong 21 percent to 1,795 in FY 1987 (ended March 31, 1988). The field remains dominated by foreign data bases, which hold 76.3 percent of the market. The number of domestic information files expanded at a faster rate than foreign products in FY 1987, 43.6 percent versus 15.4 percent, pointing to the domestic industry's vigor (see Table 1). Japanese data bases are becoming increasingly accessible overseas but face inherent problems.

Table 1: Data Bases in Japan, FY 1982-FY 1987

(number and percent)

	<u>Foreign</u>		<u>Domestic</u>		<u>Total</u>
	<u>Number</u>	<u>Share</u>	<u>Number</u>	<u>Share</u>	
FY 1982					
Registered	472	78.1%	132	21.9%	604
Actual	334	73.2	122	26.8	456
FY 1983					
Registered	743	81.1	173	18.9	916
Actual	522	76.9	157	23.1	679
FY 1984					
Registered	1,034	83.3	208	16.7	1,242
Actual	725	78.5	199	21.5	924
FY 1985					
Registered	1,401	82.3	301	17.7	1,702
Actual	1,008	78.2	281	21.8	1,289
FY 1986					
Registered	1,617	82.5	342	17.5	1,959
Actual	1,187	80.0	296	20.0	1,483
FY 1987					
Registered	1,820	74.6	620	25.4	2,440
Actual	1,370	76.3	425	23.7	1,795

Note: "Actual" figures reflect the elimination of double counting.

Source: Ministry of International Trade and Industry

MITI's annual data base industry survey underscores the difficulty Japanese data base companies face in competing with foreign products. Since commercially available data bases have existed in the United States from the early 1960s, the amount of information they contain far exceeds what the Japanese have to offer. Japanese firms are unlikely to close the gap since they would not only have to enter all current information but also enter data going back more than two decades. This problem is compounded given the breadth of American data bases such as Dialog and Nexis, which cover thousands of publications. So far, the domestic industry's share has hovered around one-quarter of the market.

The number of domestic offerings, however, has grown faster than foreign data bases in two of the last three fiscal years. Japanese companies have realized that they cannot compete with foreign data bases head to head. Instead, they are offering unusual or specialized services, such as employment bulletin boards and local news services. In FY 1987 the strongest area of growth for Japanese firms was in business data bases, which expanded at an overall rate of 41.3 percent (see Table 2). The new emphasis on economic restructuring and domestic demand shows up in the 100 percent-plus growth rates of files containing domestic economic and corporate data. Booming Japanese equity, bond and foreign exchange markets sparked the 61.5 percent growth in stock, bond and exchange rate data bases. Surprisingly, travel and leisure-related data bases showed only moderate growth in FY 1987.

The data base industry pulled out of a slump in FY1987, with the number of providers rising 21.9 percent and the number of distributors increasing 14.7 percent (see Table 3). Data base research firms also multiplied in FY 1987, although at a slower rate than the previous year (17.1 percent versus 25 percent). One interesting trend is that the number of companies offering data bases as a sideline is several times the number of primary providers. In the research field, however, a more even balance has been struck between primary and secondary businesses since FY 1986.

The number of Japanese data bases available overseas is also climbing, according to a survey by the Japan Database Industry Association. A total of 83 data bases were offered overseas by 29 organizations as of July 1988, well above the 28 available as of March 31, 1987. Business, finance and economic information represented 61 percent (51 data bases) of all offerings abroad, followed by 20 science and technology data bases or 24 percent, and general information files with 17 percent (14 data bases). (Two of the data bases cover more than one area and so are counted twice.) According to DINA, another 30 data bases are being prepared for foreign customers. By country, the United States has access to all but 14 of the 83. Europe is close behind with access to 64.

DINA also describes major obstacles to a greater share of the global data base market for Japanese firms. First is the fact that Japanese data bases are in Japanese, a language not widespread outside the country. The cost of translating from Japanese into Western languages is currently enormous. Even if translating computers become available, it will take time to convert the information. In contrast, American data bases are naturally compiled in English. Moreover, American data bases are easily and cheaply exportable, with no time delay between data entry and availability. The global lack of computer

Table 2: Japanese Data Bases by Topic, FY 1986-FY 1987

(number of registered data bases)

	FY 1986	FY 1987		FY 1986	FY 1987
General data bases			Education	22	19
General information	54	65	Sociology	14	14
News	72	145	Population statistics	10	12
Biographical, company data	55	55	Law	1	2
Management	30	28	History	4	4
Law	34	32	Art	8	9
Politics	27	24	Psychology	9	9
Health, sports	8	8	Linguistics	5	5
Travel, reservations	10	16	Philosophy	2	2
Leisure, entertainment	14	18	Religion	9	8
Popular culture	13	16	Other	1	1
Dictionary, glossary	20	23	Subtotal	102	101
Geography, cartography	6	4	Business		
Other	22	23	General information	74	94
Subtotal	365	457	Market, product data	89	120
Natural sciences, technology			Foreign economic data	133	168
General information	64	63	Domestic economic data	35	90
Patents	62	65	Foreign corporate data	154	179
Life sciences*	142	157	Domestic corporate data	58	122
Chemistry	72	75	Accounting, management	19	21
Physics	5	5	Stock and bond quotations, exchange rates	135	218
Mathematics	5	5	Energy	40	65
Electricity, electronics, computers	91	81	Telecommunications, transportation	20	21
Industrial, mechanical	10	12	Agriculture	24	13
Construction	14	15	Chemistry	11	16
Space, geophysics, oceanography	21	24	Labor	13	11
Nuclear power	1	3	Architecture, construction	6	7
Environment	32	36	Transportation	16	20
Energy	29	28	Retail, services	4	7
Agriculture	23	24	Real estate	3	4
Meteorology	12	14	Other	24	36
Metallurgy	18	20	Subtotal	858	1,212
Food	9	9	Miscellaneous		
Textiles	8	8	Other	3	2
Other	13	24	Subtotal	3	2
Subtotal	631	668	Total	1,959	2,440
Social science, culture					
General information	17	16			

*Such as biology, anatomy, pharmacology and veterinary science.

Source: Ministry of International Trade and Industry

Table 3: Japan's Data Base Industry, FY 1982-FY 1987

(number of companies)

	<u>Primary Business</u>	<u>Secondary Business</u>	<u>Total</u>
Data Base Producers			
FY 1982	6	24	30
FY 1983	8	29	37
FY 1984	13	42	55
FY 1985	21	52	73
FY 1986	18	55	73
FY 1987	19	70	89
Data Base Distributors			
FY 1982	17	30	47
FY 1983	22	29	51
FY 1984	24	48	72
FY 1985	32	58	90
FY 1986	20	55	75
FY 1987	16	70	86
Data Base Research Firms			
FY 1982	3	10	13
FY 1983	3	10	13
FY 1984	4	20	24
FY 1985	9	19	28
FY 1986	18	17	35
FY 1987	20	21	41
Data Base Agencies			
FY 1986	3	11	14
FY 1987	4	13	17

Source: Ministry of International Trade and Industry

equipment that can display Japanese characters is another barrier cited by DINA since users may not be willing to buy a piece of equipment dedicated solely to Japanese data bases. Innovative software may alleviate this problem but cannot address the language barrier. Japanese data base providers also have been slow to offer 24-hour service, a very important consideration if the user is halfway around the world. Finally, Japanese firms lack the marketing experience to design user-friendly data bases and advertise them effectively in foreign countries. The Japanese data base industry is clearly growing and maturing but remains a minor player compared with American and European firms.

Jon Choy

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J A P A N · E C O N O M I C · I N S T I T U T E

JEI

R E P O R T

A Two-Part Report: A and B

NO. 40A

October 21, 1988

THE YEN SINCE THE PLAZA ACCORD

Summary

At times during 1988 the dollar has been worth only half as many yen as three years earlier. The two currencies have been roughly stable against each other during most of 1988, but the dramatic changes associated with the exchange rate realignment since 1985 are still being played out in Japan.

While it is customary to focus on the yen-dollar exchange rate and Japan's dollar-denominated current account balance, looking at other measures of both the value of the currency and the external balance reveals a picture sometimes at odds with those measures. And, while the realignment is usually dated as having begun with the Plaza Accord of September 1985, it may have started earlier in 1985, casting some doubt on the role of international economic policy coordination as exemplified in the accord.

Background

On September 22, 1985 the finance ministers and central bank governors of the world's five leading industrial countries held an extraordinary meeting at the Plaza Hotel in New York City. Their purpose, spelled out in one paragraph of a much longer document issued after the meeting, was clear:

The Ministers and Governors agreed that exchange rates should play a role in adjusting external imbalances. In order to do this, exchange rates should better reflect fundamental economic conditions than has

been the case. They believe that agreed policy actions must be implemented and reinforced to improve the fundamentals further, and that in view of the present and prospective change in fundamentals, some further orderly appreciation of the non-dollar currencies against the dollar is desirable. They stand ready to cooperate more closely to encourage this when to do so would be helpful.¹

With this statement, the United States dropped the last vestiges of the so-called benign neglect of the dollar and agreed to work actively to reduce its value. The communique stood in marked contrast to a statement from the 1983 Economic Report of the President, released in February 1983:

Since 1981 the United States has abstained as much as possible from direct intervention in the foreign exchange market. This unwillingness to intervene is based on doubts about whether exchange-market intervention is effective or desirable.²

September 22 was a Sunday in New York. Although it was Monday in Tokyo, the markets there were closed for a holiday. When the American and the European markets opened the next day, the reaction was swift. In London, for example, the dollar dropped in a single day by 3.5 percent against the yen and comparable amounts against the other currencies.

But many remained skeptical that a mere dictum from the economic officials of the Group of Five nations would be enough to drive the dollar down. While the communique recommended various measures for governments that would lead to a cheaper dollar, many experts felt the recommendations did not go far enough to spell out specific actions. Japan, for example, pledged "flexible management of monetary policy with due attention to the yen rate." In this case, Japan did respond, perceptibly, if temporarily, tightening monetary policy. The three-month gensaki interest rate jumped from 6.3 percent on average in July-September 1985 to 7 percent in the October-December period; long-term rates also climbed. The higher interest rates were designed to keep a portion of Japan's capital outflow at home and reduce the supply of yen on international money markets, driving the Japanese currency up. By the first quarter of 1986, however, both short- and long-term rates were below their July-September levels.

While the deliberations and the documents that led up to the Plaza Accord have not been made public, Yoichi Funabashi, a deputy editor of economic affairs at Asahi Shimbun has written about the process. He suggests that the

¹Announcement of the ministers of finance and the central bank governors of France, West Germany, Japan, the United Kingdom and the United States, September 22, 1985.

²Council of Economic Advisers, Economic Report of the President 1983 (Washington, D.C.: Government Printing Office, 1983), p. 68.

officials had in mind a comparatively modest appreciation of the yen against the dollar over the short term. Mr. Funabashi describes discussions about whether the dollar should drop to the Y214-Y218 range, a 10 to 12 percent depreciation from its pre-Plaza level of Y242=\$1.00, or sink further, perhaps to around 200 yen to the dollar.³

If the participants wanted a modest depreciation of the dollar, they got considerably more. The dollar fell rapidly, closing 1985 at Y200.5=\$1.00 and plummeting to Y179.60=\$1.00 by the end of the first quarter of 1986, a drop of 25.8 percent against the yen from the pre-accord level. One major factor was falling oil prices, which plunged more than 50 percent in dollar terms in the six months following the accord. The yen strengthened against the dollar as the Japanese demand for foreign currency to pay for imported oil declined.⁴

The individual Plaza Accord participants or their representatives met several times in late 1985 and in 1986 in an effort to keep the agreement on track. But by early 1987 the finance ministers and the governors appeared to have had enough. With the yen at Y154=\$1.00, they met again, this time in Paris, on the weekend of February 21-22 to hammer out what has become known as the Louvre Accord. Japan was represented by its new finance minister, Kiichi Miyazawa, replacing Noboru Takeshita, who had participated at the meeting in New York. Canada and Italy were added to the five countries that had signed the Plaza Accord, although Italy stomped out of the meetings when it was not invited to a dinner of the original five. (Canada did not seem to mind the snub.) The result was a Group of Six communique, which said in part:

The Ministers and Governors agreed that the substantial exchange rate changes since the Plaza Agreement will increasingly contribute to reducing external imbalances and have now brought their currencies within ranges broadly consistent with underlying economic fundamentals, given the policy commitments summarized in this statement. Further substantial exchange rate shifts among their currencies could damage growth and adjustment prospects in their countries. In current circumstances, therefore, they agreed to cooperate closely to foster stability of exchange rates around current levels.⁵

Having appeared to be successful at jump-starting the exchange rate adjustment mechanism a year and a half earlier, the ministers were now attempting to bring it to a screaming stop. Once again, skepticism abounded. The U.S. trade deficit had responded relatively little to the dollar depreciation to date, so it was hard to see why then-current rates were the appropriate ones if the object were to reduce external balances. Further, many doubted the efficacy of the Louvre commitments, which were supposed to improve the chances of obtaining exchange rate stability.

³Yoichi Funabashi, Managing the Dollar: From the Plaza to the Louvre (Washington, D.C.: Institute for International Economics, 1988), pp. 16-18.

⁴For a description of developments immediately following the Plaza Accord and how they affected the yen, see Takatoshi Ito, "The Intra-Daily Exchange Rate Dynamics and Monetary Policies After the G-5 Agreement," Journal of the Japanese and International Economies, 1 (1987), pp. 275-298.

⁵Group of Six Communique, February 22, 1987.

In the Louvre communique, Japan promised to:

... follow monetary and fiscal policies which will help to expand domestic demand and therefore contribute to reducing the external surplus. The comprehensive tax reform, now before the Diet, will give additional stimulus to the vitality of the Japanese economy. Every effort will be made to get the 1987 budget approved by the Diet so that its early implementation [can] be ensured. A comprehensive economic program will be prepared after the approval of the 1987 budget by the Diet, so as to stimulate domestic demand, with the prevailing economic situation duly taken into account. The Bank of Japan announced that it will reduce its discount rate by one-half percent on February 23.⁶

Japan has attempted every one of the initiatives laid out in the communique. So far only the effort at tax reform has fallen short, although Japan is now in the midst of a special Diet session called specifically to deal with this issue. The centerpiece of the Japanese effort to meet its promises outlined in the Louvre Accord was a Y6 trillion (\$42.9 billion at a then-current Y140=\$1.00) supplemental package of spending increases and tax cuts for FY 1987, which ran from April 1, 1987 to March 31, 1988 (see JEI Report No. 21B, June 5, 1987).

For a while the Louvre Accord seemed to be working. The yen-dollar exchange rate moved around a little but showed no clear direction during the spring and summer of 1987. For July 1987 it averaged Y150=\$1.00, close to its February level of Y153. Furthermore, the policies that were supposed to be the glue that held the agreement together were jelling, at least in Japan. Japan's economy, which had been reeling under the impact of the high yen, was showing signs of coming to life, although the phenomenon is clearer in hindsight than it was at the time. Just as called for in the Louvre Accord, growth stemmed entirely from domestic demand, with external demand falling. In the July-September 1987 quarter real gross national product surged 8.4 percent on an annual basis.

Then the roof fell in, and policy disagreements between the United States and West Germany may have played a part. Interest rate changes here and abroad had the effect of making investment in the United States less attractive, altering the relative price of equities and bonds and, generally, undermining confidence. On October 19, 1987 (Black Monday) equity prices plummeted around the world, underscoring the interdependence of world financial markets that had been one of the reasons for policy coordination as exemplified in the Plaza and the Louvre Accords.

If Black Monday demonstrated the rationale for policy coordination, it failed to demonstrate its effectiveness. In fact, some argued, the exchange rate stability over the summer had created an illusion of equilibrium in the underlying economic relationships. Attempts to maintain that illusion, in this view, had led to the interest rate structure that had contributed to the crash. These analysts, in other words, blamed Black Monday in part on the Louvre Accord.

⁶Ibid.

The crash itself had ambiguous effects on the exchange rate. Americans pulling money out of the Tokyo stock market created a supply of yen as they moved to cash in their yen proceeds for dollars, pulling the yen down and pushing the dollar up slightly. From the Friday before Black Monday to the Friday after, the yen went from Y142=\$1.00 to Y144. By early November, however, the effect appeared negative for the dollar, and the U.S. currency resumed its rapid descent. While averaging Y144 for October, the month of the crash, the dollar traded at only Y128.35 for December 1987. In late December the Group of Seven ministers reiterated their commitment to stable currencies. The yen closed 1987 at Y123.5=\$1.00.

The first nine months of 1988 have largely been a replay of the same period of 1987, with the dollar stable or rising slightly against the yen. Should the stability last much past the first anniversary of Black Monday on October 19, the yen may end up higher at the end of 1988 than a year earlier (see JEI Report No. 40B, October 21, 1988). The recent stability makes it easy to forget that the yen has appreciated about 86 percent against the dollar (Y242 to Y130) since the Plaza Accord barely three years ago.

The Question of Coordination

The Plaza Accord was a turning point in the Reagan administration's policy toward currency markets. Rather than let the dollar find its own level, Washington agreed to intervene to help establish a value for the U.S. currency against other currencies. In so doing, Treasury Secretary James A. Baker III reversed the course set by the administration's first treasury secretary, Donald Regan. The new policy in some eyes amounted to a violation of the free-market principles that have driven so many Reagan White House positions. The Louvre Accord was an even greater departure; in essence, the agreement amounted to an effort to fix one of the economy's key prices, that of its currency.

The ministers and the governors who gathered in New York and later in Paris were smart enough to realize that their words alone could not command markets. Even if the central bankers threw billions into intervention, the currency markets would move only temporarily if the tens of billions that the private sector could command bet otherwise. In this sense, the officials bought the argument that price-fixing, whether of currencies, gasoline or other goods and services, is likely to be ultimately disappointing, regardless of its superficial appeal.

For this reason, the ministers went much further in the Plaza and the Louvre Accords: they agreed to take steps to change the fundamental supply and demand conditions for their currencies. With their sway over the money supply and influence on government tax and spending decisions, economic policymakers around the world come far closer to controlling the commanding heights than they do the everyday operations of the currency markets.

A primary objective of international economic policy coordination as practiced during the past three years has been reducing external imbalances -- especially the huge U.S. current account deficit and the enormous Japanese current account surplus. The central bankers and the finance ministers who gathered in New York and Paris saw these as troublemakers for two main reasons:

- They are necessarily associated with a corresponding capital flow in the other direction. Foreign investors, for example, help finance the U.S. deficit when they build factories, buy real estate, or purchase U.S. government and corporate securities. Partly because there is no consensus on why foreigners put their money in the United States, the ever-present fear is that they will stop. Should the foreign demand for dollars for investment diminish, the dollar's value would drop, perhaps dramatically. In addition, falling investment in securities could depress stock and bond prices, pushing up interest rates.

On the other hand, even if foreigners could somehow be induced to keep buying U.S. government and corporate securities indefinitely and making direct investments here, the problem would eventually be just as serious. The country's current account deficit would slowly spiral out of control as interest and dividend payments on accumulated portfolio and direct investment loomed larger, requiring ever-larger infusions of foreign capital unless other imbalances making up the current account improved significantly.

- All the parties to the Louvre and the Plaza Accords had an interest in resisting protectionist pressure in the United States. The Europeans and the Japanese saw protectionism as threatening their markets here, and Washington wanted to stay true to its free-market ideology. Large U.S. trade deficits were felt to fan the protectionist flames.

To attack the external imbalances, the finance ministers and the central bankers could target three main variables: exchange rates, rates of growth of national output and interest rates. But there was a problem -- the three are interrelated. The trick was to pull the policy levers in such a way that a consistent set of the three would emerge in each country that would serve to reduce the current account deficit of the United States and the surplus in Japan and elsewhere.

The Plaza and the Louvre Accords used different combinations of these policy instruments to deal with the same problem, external imbalances. The former emphasized exchange rate adjustments that were supposed to lead to export and import price changes. The appreciation of the yen was intended to drive up the dollar price of Japanese exports and reduce the price of imports, with both effects eventually working to reduce Japan's trade surplus. The depreciation of the dollar, on the other hand, was supposed to work comparable magic on the U.S. deficit.

In the Louvre Accord the problem was the same, but the solution was somewhat different. The adjustment of export and import prices as a path to external balance was deemphasized. Instead, a faster rate of economic growth in Japan, helped along by expansionary fiscal and monetary policies, was supposed to pull in more imports and, perhaps, help Japanese exporters find alternative markets at home. The United States repeated its pledge made in the Plaza Accord to attend to its budget deficit, although there was some skepticism about how much it really intended to do. The smaller the federal budget deficit, the lower would be the demand for funds to finance it and, other things being equal, the lower U.S. interest rates would be. Lower interest rates, in turn, should prove less of a magnet for funds from abroad, thereby reducing one source of the current account deficit.

Japan's own external imbalance probably also would decline if the U.S. budget deficit fell. Japan has a very high level of savings relative to its domestic needs. With high interest rates here, the United States has looked

very attractive as a place to invest those savings. A lower U.S. budget deficit would make investment here much less enticing, implying less inflow to the United States and a smaller bilateral imbalance.

The rationale behind the Plaza and the Louvre Accords is that, in an interdependent world, the costs and benefits of economic policies cross national boundaries, implying that, absent coordination, no country reaps the full rewards of or pays the full price for its actions. Multilateral negotiation can, in principle, result in beneficial trade-offs among the participant countries, thereby inducing them to pursue enlightened policies.

Further, international economic coordination is more effective, and perhaps less painful to the participant countries, than individual actions to reduce the external imbalances. For example, if both Japan and West Germany allow their currencies to rise in value, the amount of appreciation required of either to reduce their current account surpluses with the United States by a given amount is that much less. The pain, should there be any, diminishes proportionately to exporters in West Germany and Japan. And, of course, any individual action is less likely to provoke a counterproductive response if explained in advance to the finance ministers and the central bankers of other countries.

While this idea has gained wide acceptance, not everyone buys it. (For a detailed pro and con discussion of this issue, see JEI Reports No. 25A, July 1, 1988, and No. 26A, July 8, 1988.) Among the most vociferous critics has been Martin Feldstein of Harvard University, who not coincidentally was the second chairman under President Reagan of the Council of Economic Advisers. During his tenure the dollar soared against most major currencies, a process the administration did little to slow or reverse.

Mr. Feldstein and others make several points that challenge both the desirability and the feasibility of coordination:

- Coordination of exchange rate policies, they believe, promises more than can possibly be delivered in a democracy. Finance ministers and central bankers can make all the promises they want to their foreign counterparts, but they cannot necessarily bring along their legislatures or even their chief executives. Three years after the Plaza Accord, the world is still awaiting substantial progress on the U.S. budget deficit. A year and a half after the Louvre Accord, Japan has yet to deliver on its pledge of tax reform.

- Coordination often suggests an ability that is likely to prove elusive to either stabilize or move exchange rates. Mr. Feldstein argues that the influence of the Plaza Accord on currency markets has been overrated, pointing out that the dollar actually peaked against the yen in February, not September, 1985. Further, the dollar depreciated against a weighted average of industrial countries' currencies at the same rate in the year after the Plaza Accord as in the six months preceding it.⁷

Mr. Feldstein's argument comes close to suggesting that, even without the Plaza Accord, the G-7 countries may have gotten what they apparently

⁷Mr. Feldstein has made essentially similar points in several articles in academic and non-academic publications. On the question of the Plaza Accord's effectiveness and for references to other articles, see Martin Feldstein, "Correcting the Trade Deficit," Foreign Affairs, Spring 1987, pp. 795-806.

wanted: a slow depreciation of the U.S. currency. If so, the result of the accord was to advance part of the depreciation into the six months immediately after the New York meeting, with little net effect by the time a year had passed. Given an objective of a dollar valued at Y200 or a little more, the data do not convincingly show that the Plaza process got the world there any more safely than a totally uncoordinated process would have. The Louvre Accord, by contrast, advocated stable exchange rates, but the calm that followed led in short order to a financial panic on Black Monday and a falling dollar anyway.

- International policy coordination involves making choices about real or imagined trade-offs among unemployment, inflation, interest rates, exchange rate stability and other objectives. Nations naturally differ as to the weights they assign to these goals. International economic policy coordination, in other words, involves accepting to some extent another country's objectives. Europeans clearly value exchange rate stability for its own sake, Americans generally do not, and Japan is somewhere in-between. This variation might still allow successful pursuit of some overarching goals such as reducing external imbalances. However, even successful policy coordination does not ensure that these larger goals will be obtained.

- Policy coordination, its critics point out, makes all industrial countries responsible on paper but in practice no one takes responsibility. Hence, Tokyo can (and does) point at Washington for not living up to its end of the deal; Washington in turn fingers Bonn. Each one may be right: many of the policy recommendations involve painful political choices that are resisted.

Academic researchers have wrestled with the question of whether policy coordination is a good idea, often using complex formal economic models. Many have shown that the process results in small gains to the coordinating countries, but Jeffrey Frankel argued that policy coordination in a world where economic relationships are poorly understood produces less optimal results than those based on completely uncoordinated policies.⁸ On the other hand, Atish R. Ghosh and Paul R. Masson argued that, provided the economic relationships are known to be uncertain, policy coordination results in some improvement compared to when there is no effort at coordinating policies.⁹

Measuring the Yen's Appreciation

Figure 1 shows the month-by-month path of the yen-dollar exchange rate since the January preceding the Plaza Accord. For comparison purposes, Figure 2 shows the year-to-year relationship since 1970. While the yen's change against the dollar has received the greatest publicity and has been the most dramatic, concentration on the dollar obscures the real picture of yen appreciation since 1985. For most of the period since the Plaza Accord, the yen has appreciated modestly against European currencies such as the Deutsche mark, changing only from 81.5 yen per Deutsche mark on September 30, 1985 to 78.5 yen per Deutsche mark on December 31, 1987. Since then the two currencies have become decoupled: by early October 1988 the Deutsche mark had dropped to 71.6 yen.

⁸Jeffrey Frankel, "Obstacles to International Macroeconomic Policy Coordination," IMF Working Paper WP/87/29 (unpublished paper, International Monetary Fund, 1987).

⁹Atish R. Ghosh and Paul R. Masson, "International Policy Coordination in a World with Model Uncertainty," International Monetary Fund Staff Papers, June 1988, pp. 230-258.

Figure 1: Monthly Yen - Dollar Exchange Rate
January 1985 - September 1988

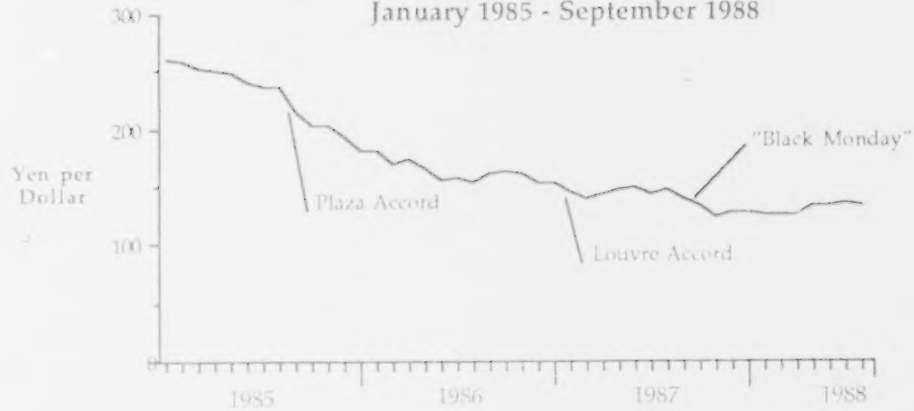
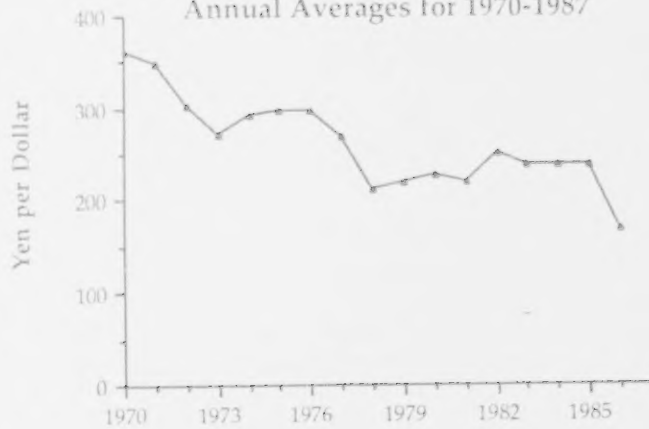


Figure 2: Yen - Dollar Exchange Rate
Annual Averages for 1970-1987



The yen's changes against Asian currencies have been more dramatic. The Japanese yen was worth 3.25 South Korean won on average in the third quarter of 1985, before the Plaza Accord could have had much effect on exchange rates. Since then the yen has appreciated almost constantly against the South Korean currency; by the second quarter of 1988 it fetched 5.9 won, a nominal yen appreciation of 81.5 percent. The substantially higher rate of inflation in South Korea -- where consumer prices rose 6.4 percentage points faster than in Japan in the twelve months ending in March 1988 -- has not been enough to offset the exchange rate change. The yen also has appreciated a nominal 72.5 percent against the Singapore dollar even though rates of inflation were slightly higher in Japan. The result has been a substantial real appreciation against these and most other Asian currencies.

Looking at each country's real, trade-weighted exchange rate index sorts these effects out. Compiled by the International Monetary Fund, the index adjusts for changes in unit labor costs, which are themselves adjusted for changes over the business cycle. Hence, when the Japanese economy was expanding rapidly in the first quarter of 1988, unit labor costs fell. This contribution to the real appreciation of the yen, however, was less than if the drop in unit labor costs had not been partly attributable to the strong economy.

This measure shows that the initial effect of the currency realignments that began in 1985 was to reverse the changes that had occurred since 1980 (Table 1). The Japanese currency recovered its real 1980 level by the fourth quarter of 1985, while it took the West German currency another year to obtain this value. The dollar fell continuously in real terms nearly every quarter but remained above 1980 values in real terms until the last quarter of 1987. Even the most recent data, for the April-June 1988 quarter, show the dollar only about 8 percent below where it was in 1980, once unit labor costs are taken into

Table 1: Real Effective Exchange Rates

(1980 = 100)

	<u>Japan</u>	<u>United States</u>	<u>West Germany</u>	<u>United Kingdom</u>
1985: Q1	99.2	155.8	87.9	87.9
Q2	97.5	150.6	88.2	95.4
Q3	97.4	142.7	90.0	99.6
Q4	104.9	132.6	92.6	97.4
1986: Q1	113.1	123.5	95.4	91.5
Q2	121.4	118.2	95.7	94.2
Q3	128.6	112.3	98.1	89.8
Q4	122.6	111.6	101.2	86.3
1987: Q1	122.3	104.5	104.0	88.6
Q2	127.6	101.0	104.1	92.9
Q3	124.8	102.2	103.3	94.2
Q4	128.7	95.8	105.7	98.2
1988: Q1	134.2	92.5	105.5	99.7
Q2	137.3	91.7	104.5	104.2

Source: International Monetary Fund

account. The yen, on the other hand, is 37.3 percent higher. Put differently, the realignment of currencies has been more complicated than the dollar merely dropping and the yen rising. As recently as a year ago, the United States, West Germany and Japan all had currencies that had appreciated in real terms during the 1980s. Had exchange rates stayed in the range prevailing at the time of the Louvre Accord, that situation would still be true today.

The figures also suggest that concentration on the nominal yen-dollar exchange rate has substantially overstated the effect of currency realignment since late 1985. The yen-dollar rate has changed significantly more than either currency has in real trade-weighted terms. Against the yen the dollar depreciated 47 percent in nominal terms between the third quarter of 1985 and the second quarter of 1988, but in real, trade-weighted terms it was down 36 percent.

The same is true for the yen. While the Japanese currency had appreciated by 90 percent in nominal terms against the dollar by the second quarter of 1988 compared to the third quarter of 1985, in real, trade-weighted terms the appreciation came to only 41 percent, less than half as much. To the extent that the yen's appreciation hurts, the real exchange rate is a better measure of pain. On that basis Japan has suffered less than it appears.

Effects of the Yen's Appreciation

Of course, the effects of the stronger yen on the Japanese economy were large and almost immediate. The economy went into a recession, which now appears to have bottomed out in late 1986 or early 1987. Since then growth generally has been rapid, although there has been substantial quarter-to-quarter variation. During most of the period, the external sector has been a drag on the economy's performance, sometimes enough to pull the overall rate into negative figures (see Table 2).

Table 2: External Sector and Real Japanese Growth

(contribution to seasonally adjusted quarterly growth rates)

	<u>Exports</u>	<u>Imports</u>	<u>Net Exports</u>	<u>Domestic Demand</u>	<u>Overall Growth</u>
1985: Q4	-0.3%	0.2%	-0.1%	1.3%	1.2%
1986: Q1	-0.7	0.1	-0.6	0.0	-0.6
Q2	0.2	-1.2	-1.0	1.9	0.9
Q3	-0.1	0.0	-0.1	1.0	0.9
Q4	-0.1	0.1	0.0	0.7	0.7
1987: Q1	0.4	0.1	0.5	1.0	1.5
Q2	-0.3	-0.9	-1.2	1.2	0.0
Q3	1.1	-0.9	0.2	1.8	2.0
Q4	-0.2	-0.4	-0.6	2.4	1.8
1988: Q1	0.7	-0.8	-0.1	2.8	2.7
Q2	-0.7	-0.8	-1.5	0.5	-1.0

Source: Economic Planning Agency

The negative contribution to economic growth by the external sector since 1985 reversed the pattern of the previous half decade. In both instances, though, the influence of the external sector one way or the other was less important than the much larger domestic sector. For example, in FY 1984 (April 1984-March 1985) the external component contributed only 1.2 percentage points of the overall growth of 5.1 percent. FY 1986 was the first year since FY 1978 to show a negative contribution from the external sector.

Of course, the soaring yen brought many benefits. Oil, which is priced in dollars, became cheaper, as did many other products. More generally, lower prices for imports led to increased purchasing power, enabling Japanese consumers to spend more on both imported and domestically produced goods and services. In other words, while the yen undoubtedly had a negative effect on the net exports component of gross national product, it had a positive effect on other components of GNP.

While some domestic industries are still in the doldrums, the Japanese are rapidly forgetting how worried everyone was in early 1986 about the yen's appreciation. By many measures the economy is now far healthier than it was before the yen rose in value. For example, the effective job-opening ratio, considered a good barometer of employment opportunities, stood at 1.07 in August 1988, indicating an excess of employment opportunities over those seeking employment and the most favorable level since the early 1970s. Profits of manufacturing firms, many of which are export-oriented, sank as the yen rose but are now recovering on the strength of domestic demand and firming export markets.

Even if the yen stays in its present range, the effects of its appreciation between 1985 and 1987 will continue to work their way through the economy for some time. For example, some portion of Japan's soaring direct foreign investment is attributable to the country becoming a high-cost producer in a wide variety of products. With new announcements of foreign production plants coming almost daily and with planning, construction and startup production each taking at least months more, the effect of foreign investment decisions will be felt for years.

For those abroad the bottom line of the yen's appreciation is its effect on Japan's current account surplus. Complicating the assessment is a number of factors:

- The figure usually reported is the dollar value, but this amounts to using a rubber yardstick. International transactions with a constant volume show up as higher dollar figures, magnifying surpluses. Partly for this reason, the short-run response to the yen's appreciation was an increase in the surplus.

- External accounts are affected by many influences other than the exchange rate. One important additional factor has been the strength of the U.S. economy, which has kept the demand for Japanese exports strong.

- Seasonal factors play a major role, making unadusted month-to-month comparisons difficult.

- Some reactions to the strong yen have short-run perverse effects on the current account. For example, to the extent that Japanese manufacturers move production offshore but use Japanese-made equipment, Japanese exports

increase. At the same time, to the extent that U.S. firms become more competitive, they may expand capacity using, in part, products imported from Japan.

- Some firms have multi-year import contracts with Japanese suppliers.
- Past and ongoing foreign investment has resulted in an increased flow of dividend and interest income to Japan, which also tends to increase the current account surplus.

Japan's dollar-denominated current account surplus increased in 1986 and again in 1987. In 1988 it has declined on a year-to-year basis, although it is still very high by historical standards. Similarly, Japan's trade surplus with the United States has grown every year since 1981, although it was lower in each of the first nine months of 1988 than in the corresponding month a year earlier.

Over time Japan's trade structure will change. Exports to those countries whose currencies have depreciated the least against the yen are likely to be a larger fraction of total Japanese overseas sales. Reflecting this, the share of Japanese exports going to North America declined sharply in 1987, reversing the previous trend (see JEI Report No. 16A, April 22, 1988). Unless Asian currencies appreciate against the yen, much of Japan's import growth will come from that region. U.S. exports to Japan also are likely to rise as a result of the weak dollar.

Outlook

The yen-dollar exchange rate at any given moment reflects the consensus of all those who trade currencies or invest internationally. Investor behavior gives clues as to which direction exchange rates are likely to move.

Interest rates by most measures are higher in the United States than in Japan, and Japanese investors allocate a portion of their multibillion dollar portfolios to American assets. This suggests that, on balance, they are willing to invest in the United States, but only if they get a high enough rate of return to offset possible dollar depreciation and future swings in interest rates that could decrease the dollar value of their investments. If Japanese investors were confident of avoiding those pitfalls, they would put much more money here. Similarly, if U.S. investors were certain that they could avoid these problems, they would not invest abroad at all, yet they do. The consensus, then, appears to be that the dollar will continue declining. Given that the interest rate differential is small, the expectation is that the dollar's decline will be gradual.

Japanese life insurance companies may have employed just this logic in mid-1985, increasing their dollar-denominated investments because the difference in yield appeared to be enough to compensate for any risk. They were wrong, and they have paid a multibillion dollar price for their error. Yet they continue to invest here, apparently believing they were just unlucky before. With their billions of dollars at stake and sophisticated analyses, Japanese insurance companies illustrate the perils of trying to guess exchange rate movements.

In one sense, knowing the future yen-dollar exchange rate is unnecessary. The changes of the past three years have affected Japan in ways that may be irreversible. As the yen's appreciation has increased prices in Japan relative to the rest of the world, Japanese firms have rapidly increased their investments abroad, and Japanese consumers have become more accustomed to buying foreign products and traveling overseas. These trends may yet level off or even reverse but, should they accelerate, Japan will emerge a dramatically different country.

For further information, contact Douglas Ostrom.

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The views expressed in this report are those of the author and do not necessarily represent those of the Japan Economic Institute.

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JEI

R E P O R T

A Two-Part Report: A and B

NO. 41A

October 28, 1988

THE OPPOSITION PARTIES IN JAPANESE POLITICS

Summary

Japan's opposition parties, which together hold 300 of the 758 seats in both houses of the Diet, have been described as a "permanent opposition" since, to date, they have been unable to break the Liberal Democratic Party's 30-plus years of uninterrupted rule. This has been due to an apparent conservative shift in Japanese voting behavior, the divisions among the numerous opposition parties and their inability to adapt their rhetoric and political agenda to social and economic developments. The parties' failures to exploit LDP factional feuds or capitalize on public opposition to certain ruling party policies at strategic moments also are factors that over the years have sealed their fates as minority players in the governmental process.

Opinion polls indicate that the Japanese public clearly believes that the LDP is the party most qualified to govern the country. Thus, it is highly unlikely that LDP dominance of Japan's political system will end in the foreseeable future. However, some Japanese political observers suggest that the non-communist opposition parties might be able to wrest some control from the ruling party by uniting as one party. In addition, internal power struggles conceivably could lead to a split within the LDP, with the splinter LDP group aligning with one of the centrist opposition parties. But the political payoffs in pursuing either scenario are highly uncertain, a factor that in the final analysis may continue to deter significant breaks from government "tradition."

The Opposition Parties: Who They Are

Japan's political system has been described as a multiparty/one-party or predominant party system.¹ There are approximately five active political parties, but one, the Liberal Democratic Party, has managed since its formation in 1955 to win an absolute majority of seats in the Diet -- even in the face of political scandals, unpopular fiscal restraint programs, inflationary pressures and other factors that would have toppled a ruling party in most any other democratic nation. The LDP has enjoyed uninterrupted rule for more than 30 years, and this leadership stability has enabled Japan to realize the kinds of political, economic and social changes that have made it the global economic power that it is today.

Although much has been written about the ruling party, comparatively less attention has been directed at the opposition parties -- the Japan Socialist Party, the Democratic Socialist Party, Komeito, the Japan Communist Party and the (now disbanded) New Liberal Club. The Diet's lower house, which is the main lawmaking body, has 510 members, of which 302 belong to the ruling party and 203 to the opposition parties with five considered independents (see Table). The LDP currently holds an absolute majority by a margin it has not enjoyed since the 1960s (see Chart). But even with the ruling party's prominent strength, some analysts contend that the gap still is not so wide as to make effective opposition impossible.

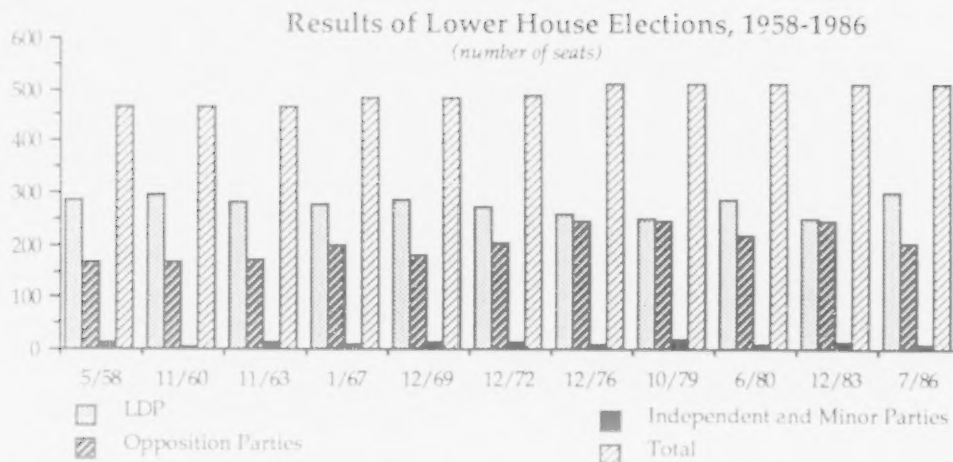
Diet Membership, 1988

	<u>Lower House</u>	<u>Upper House</u>
Liberal Democratic Party	302	144
Japan Socialist Party	86	42
Komeito	57	24
Democratic Socialist Party	29	12
Japan Communist Party	27	16
Independents	5	4
New Statesmen Club*	4	0
Niin*	0	3
Salary Workers Party*	0	3
Total	510	248

*These minor parties differ from the opposition parties in that they generally have a single-issue focus and lack a significant external supporting organization.

Source: Information Section, Ministry of Foreign Affairs

¹Ronald J. Hrebendar, "The Changing Postwar Party System," in The Japanese Party System: From One-Party Rule to Coalition Government, ed. Ronald J. Hrebendar (Boulder, Colorado: Westview Press, 1986), p. 6.



Source: Gerald L. Curtis, *The Japanese Way of Politics* (New York, N.Y.: Columbia University Press, 1988).

The LDP may have enjoyed uninterrupted rule over the years -- but not dictatorial rule. Japan's political process, after all, is democratic in nature. The ruling party generally must be responsive to opposition party interests and concerns in formulating government policy or face a public backlash. The nature and the extent of this interparty compromise has changed over the years as LDP and opposition party strengths have waxed and waned.

Why would a generally pro-LDP public react negatively to tactics in which the LDP ignores the opposition? The answer is tied up with other questions. Who are the opposition parties? Who are their constituents? How have they affected government policy? And, most important, why have they come to be considered a "permanent opposition" unable to break the LDP's leadership lock? Before tackling these questions, it is useful to review how each of these parties came into being and where they are positioned in the Japanese political spectrum.

Japan Socialist Party - Since its reorganization in 1955, the Japan Socialist Party has been the largest opposition party in the Diet. The JSP consistently has criticized the policies of the conservative majority. For a brief period in 1947 and 1948 the JSP ruled Japan as part of a coalition government, but it has yet to repeat this achievement. In fact, in recent years its support has plummeted to all-time lows. According to Japanese political experts, this decline in power and influence is due to the party's inability to adapt to economic and social change.² The JSP's political heritage is that of a party

²Gerald L. Curtis, *The Japanese Way of Politics* (New York: Columbia University Press, 1988), p. 123.

dedicated to the articulation of a world view favoring neutralism and unilateral disarmament -- a view different from that of the current government establishment. It has remained backward in adapting to new and more complex realities, especially Japan's economic growth and relatively egalitarian income distribution.

Although its ideological roots are in the proletarian movement of the 1920s, the JSP's initial popularity derived almost entirely from its opposition to constitutional reform, particularly Article IX, which prohibits Japan from ever going to war, and its opposition to Japan's rearmament and the U.S.-Japan Security Treaty. It was at this time, in the late 1950s and early 1960s, that the JSP was viewed as a potentially powerful party.

Although socialist parties traditionally have enjoyed solid backing from the blue-collar labor force, during this same period the JSP drew its support from a wide range of occupational groups: blue-collar workers, white-collar workers, farmers, merchants and small businessmen. As it does today, the JSP back then also had strong ties with the unions, particularly the Sohyo federation, which is the left wing of the labor movement. Some believe that the party then had the qualities of a catch-all political force, with a potentially wider appeal than the LDP.³ It also was viewed by many observers as likely to become the majority party as Japan became more urbanized and industrialized.

As the Japanese electorate began to enjoy the fruits of economic success and better understand the benefits of an alliance with the United States, however, the JSP's policies began to seem outmoded. Rather than adapting its platform to this changed environment, the Socialists turned inward, channeling their energies into internal leadership struggles and debates on Marxist-Leninist ideology that were of little relevance to an increasingly prosperous nation. Public interest and support for the party declined accordingly. In May 1955 the JSP obtained 32 percent of the vote; in 1976 this declined to 20 percent. In 1986 and 1987 JSP support had dropped to an all-time low of 17 percent.

Perhaps the most surprising defection of constituents was from among blue-collar voters. In the early 1960s the Socialists enjoyed the support of more than half of Japan's blue-collar workers. By the mid-1970s this level had dropped to approximately one-third, and by the mid-1980s the JSP could claim the support of only one-fifth of these voters. Privatization of Nippon Telegraph and Telephone Public Corp. and the Japanese National Railways in the 1980s also has undermined labor's ability to secure votes for the JSP. The LDP, which in 1986 received 46 percent of the blue-collar vote, clearly was seen as offering workers something more promising than was on the Socialists' menu.

As Gerald Curtis of Columbia University observes in The Japanese Way of Politics, the JSP's status as a "permanent opposition" in an LDP-dominated political system has had an enervating impact. The minority status has tended to perpetuate the party's stagnant view of itself and sapped all inspiration to develop relevant, alternative policies for the Japan of the 1980s. With no hope of coming to power, members have little incentive to play an active role in policy development or building JSP's national organization. Moreover, since there is a strong possibility of never having to implement policy proposals,

³Ibid., p. 121.

the party's leadership feels it has nothing to lose by advocating extreme or doctrinaire policies. As a result, many Japanese regard the party as poorly organized, indifferently led, narrowly based, irresponsible in policy, and lacking in policy expertise and leadership talent.⁴

Thus, in order to ensure its continued survival -- albeit in a considerably weakened role -- the JSP by necessity has compromised its "anti-system" principles by seeking accommodation with the LDP through, among other things, under-the-table deals to secure benefits for JSP supporters. This also takes the form of horse-trading. For example, the LDP will agree to a JSP walkout from the Diet in protest of a particular issue if, in return, the Socialists will agree not to obstruct action on other measures.⁵ It is a strategy of resignation -- a strategy born as hope waned of ever effectively challenging LDP supremacy.

Democratic Socialist Party - The Democratic Socialist Party is actually a splinter from the JSP. Internal ideological and policy differences within the JSP came to a head in the late 1950s when the Democratic Socialist founding group advocated a more pragmatic approach to the U.S.-Japan Security Treaty and other postwar democratization measures, rather than the JSP's virulent opposition. In the Japanese political spectrum, the DSP -- the Socialist party's "right wing" -- is considered one of the centrist parties.

When the DSP was formed in 1959, it was the third-largest party in the Diet, with 40 seats in the lower house and 17 in the House of Councillors. However, it barely survived its first general election in November 1960; only 17 of the party's 40 incumbents won re-election, and not a single nonincumbent was elected. Japanese political observers contend that the party's shaky start was due to distinct choices between the LDP/conservatives and the JSP/progressives at a time when voters were not necessarily looking for a centrist alternative. Since the DSP was neither fish nor fowl, it floundered in the middle.

For this reason, the DSP has drawn its candidates and constituent support from heavy reliance on the Domei federation, a group of trade unions that principally represent the private sector. (Domei is a right-wing splinter of the Sohyo union, much like the DSP is a conservative offshoot of the JSP.) The DSP's reliance on Domei has both helped and hurt it over the years since Domei control of its membership is weak. (Only 15 of the 31 Domei unions are listed as official supporters of the DSP.) Moreover, since the 1970s, there has been a consistent pattern of decline in the proportion of workers who belong to a labor union, particularly in the private sector. Perhaps most significant, the DSP's strong identification with Domei has limited its appeal to nonunion voters.

It comes as no surprise that the geographic distribution of DSP support mirrors Domei membership. In general, the DSP usually trails the other parties in congested metropolitan areas but tends to fare better in semirural areas.

⁴J.A. Stockwin, "The Japanese Socialist Party: A Politics of Permanent Opposition," in The Japanese Party System: From One-Party Rule to Coalition Government, ed. Ronald J. Hrebennar (Boulder, Colorado: Westview Press, 1986), p. 83.

⁵Curtis, op. cit., p. 124.

Although no match for the LDP or even the JSP in rural constituencies, it still tends to do better than Komeito.

According to the DSP's original 1960 platform, the party professes a belief in democratic socialism and its triumph over both capitalism and communism. But in terms of current domestic policies, the DSP and the LDP share very similar views. As will be discussed below, the DSP has been the most cooperative of the opposition parties during this year's Diet debate on tax reform.

The DSP's most significant policy shift -- one that clearly differentiates it from the JSP and places the party firmly in the political center -- has been in the defense area. The party's initial position stated that only "minimum measures to defend [Japan] with our own strength should be taken until a complete disarmament agreement is concluded." By 1977 this platform had shifted to offer firmer support of the Self-Defense Forces and the U.S.-Japan Security Treaty. And by 1980 the DSP had become almost hawkish on defense, urging that defense expenditures not be limited to 1 percent of gross national product.

Historically, the major difference between the LDP and the DSP concerned Japan's defense role and the security treaty. Since that is no longer a divisive issue, Japanese political experts suggest that a coalition between the DSP and the LDP or significant factions of the ruling party is not inconceivable. But given the narrow scope of its membership and the limitations posed by its ties with Domei, it is doubtful that the DSP will ever become a significant party in its own right.

Komeito - Komeito, or "Clean Government" party, was formed in 1964. It is unique in Japanese politics for two reasons. First, it did not break from any of the existing parties. And second, it is essentially a religious party; its ideology is grounded in Japanese Buddhism. Thus, in terms of ideology, basic policy orientations and social bases of support, it is difficult to classify Komeito using standard "conservative" and "liberal" political labels.

Although Komeito is the second-largest opposition party, feelings among the Japanese people toward it are seldom neutral, usually ranging from intense support to intense dislike. This lack of ambivalence stems from its creation by -- and continuing close relationship with -- Soka Gakkai, a lay organization of the Nichiren Shoshu sect of Japanese Buddhism. This organization was founded in the early 1930s and probably is best described as a Japanese equivalent to some of today's fundamentalist Christian groups but with more of a political message. "Believers" were promised health and wealth in return for their devotion to the Soka Gakkai interpretation of Buddhist doctrine. Thus, Komeito's constituency has been limited primarily to Soka Gakkai members. The party's continued efforts to tap into the non-Soka Gakkai electorate have proved unsuccessful. For its members the party draws heavily from those who have moved from rural to urban centers and have felt rootless in their new environment.

In terms of policy, Komeito initially advocated a pacifist approach not unlike the JSP. It opposed Japanese rearmament and the bilateral security treaty. However, as the alienating effect of its religious affiliation became increasingly apparent over the years, the party began in the 1970s to move closer to the DSP and the LDP on policy issues. By 1980 Komeito had dropped its call for abrogation of the security treaty and indicated greater support for the current Japanese defense buildup. However, the party has not swung quite as far to the right on this issue as the DSP. Komeito also has indicated its interest

and willingness to join an LDP-led coalition or to merge with the DSP into a broader-based centrist party, although it is unclear how receptive the other parties would be given the emotional reaction to Komeito among "non-believer" Japanese voters.

Due in large part to the moderate size and the stability of its Soka Gakkai-based support, Komeito has become the only opposition party since 1955 other than the JSP to have more than the 50 lower house seats needed to submit budget-related legislation and motions of nonconfidence in the Diet. With this sort of parliamentary presence, both the JSP and the LDP have found it necessary to seek Komeito's cooperation. Like the DSP, however, the relatively narrow scope of Komeito's membership will necessarily limit its ability to seize the reins from the ruling party.

Japan Communist Party - The Japan Communist Party, founded in 1922 but purged during the Occupation, did not begin to play a significant role in Japanese politics until the 1960s. This corresponded with its rejection of the Chinese and the Soviet communist models and its emphasis on nationalism. The late 1960s and early 1970s saw semantic changes in the JCP's platform that moved it away from Marxist-Leninist dogma and attempted to erase the totalitarian image of communism. At its July 1976 party congress, the JCP adopted a new Manifesto for Freedom and Democracy, in which it declared that a JCP-led government -- in addition to respecting civil liberties -- would permit the continued existence of a multiparty system, allow private industry to continue, and establish a foreign policy more independent from the United States -- the "three freedoms." Several analysts have observed that in an effort to broaden its appeal, the JCP attempted to give itself a "moderate Eurocommunist look."

Although the JCP has always enjoyed a strong following among intellectuals, it began during the late 1960s to make inroads into the same social groups that were attracted to Komeito. Between the elections of 1967 and 1969 the JCP tripled its number of Diet seats. In the 1972 election the number more than doubled again, to 38 seats with 10.5 percent of the popular vote.

However, as the popularity of Marxist-Leninist thought waned among Japanese intellectuals, the JCP could not sustain this momentum. Its 1972 electoral performance remains unrepeated. Not unlike the DSP, the JCP's moderate stance does not attract those interested in lodging a protest vote. And in spite of its espoused commitment to the "three freedoms," more conservative voters are still so spooked by the JCP's Marxist-Leninist roots that they could never leap that far to support it over one of the centrist parties or the LDP. According to one Japanese political observer, "The JCP occupies that awkward middle ground in which it is not revolutionary enough for the radical fringe and not trustworthy enough for the adherents of democratic socialism."⁶

In Diet politics the JCP also has found itself increasingly isolated. Both Komeito and the DSP refuse to cooperate with it, and the LDP is more likely to co-opt the centrist parties on various policy initiatives.

⁶Peter Berton, "The Japan Communist Party: The 'Loveable Party'," in The Japanese Party System: From One-Party Rule to Coalition Government, ed. Ronald J. Hrebennar (Boulder, Colorado: Westview Press, 1986), p. 139.

New Liberal Club - The New Liberal Club was disbanded in 1986, but its 10-year existence nevertheless should be mentioned, particularly in light of speculation about a future split in the LDP and/or a coalition of the centrist parties.

In July 1976 one upper house LDP member and four lower house members of the LDP broke from the party to form the NLC. Led by lower house member Yohei Kono, the group left the ruling party during what has been described as the "dark days" of the Lockheed bribery and kickback scandal, fed up and disenchanted by factional rivalries and corruption within the LDP. Prior to his departure from the LDP, Mr. Kono had established an interfactional group of young LDP members to consider reform of the party's procedures for election of a prime minister -- a process thought to be the root of many of the LDP's internal problems. He also had designs on the leadership. Thus, in mid-1976 when his study group concluded that the LDP leadership was giving only perfunctory attention to procedural reform, Mr. Kono decided to strike out on his own and establish a second conservative party, presumably one that would not be tainted with corruption and the other problems he perceived in the LDP.

In its first lower house elections, the NLC surprised its critics by garnering an impressive 13 percent of the vote. More important, it made inroads into an electoral group that the LDP could not attract and for whom the JSP no longer had any appeal -- the young, educated, urban middle class. Although there was considerable speculation in the Japanese press that the NLC would develop into a conservative party representing primarily urban, middle class interests -- leaving the LDP to represent rural interests -- this did not happen. For one thing, the NLC had trouble repeating its early success. Problems cropped up in raising funds, luring potential candidates away from the LDP and expanding its voter appeal beyond the Tokyo metropolitan area. In addition, the NLC leadership itself remained divided over the party's future, whether to act as a catalyst for LDP reform with reunion as an eventual goal or to form a centrist party alliance.

This division led to a factional breakdown, with Mr. Kono favoring an interparty merger and secretary general Takeo Nishioka pushing for LDP reunion. Mr. Kono insisted that the primary task of the NLC was the destruction of the LDP's monopoly on government rule; the only way to do that, he theorized, would be to cooperate with some of the other moderate parties, namely the DSP. Mr. Nishioka later resigned from the party, taking with him four other members from his faction.

Although the Nishioka-Kono split wielded a blow to the fledgling NLC organization, the 1979 elections, characterized by exceptionally low voter turnout, almost wiped out the party's Diet representation (it secured only four seats). However, this election also deprived the LDP of its working majority in the Diet. In response, the ruling party offered to trade a cabinet appointment for NLC support for the election of Masayoshi Ohira as prime minister. When the LDP failed to deliver on the cabinet position, the NLC once again moved toward a centrist coalition. After the 1983 election, the ruling party once again needed the NLC's support. This time the LDP made good on its promise and appointed as home minister Seiichi Tagawa (who had succeeded Mr. Kono as party head). Other NLC members receiving appointments were Toshio Yamaguchi, who became labor minister, and Mr. Kono (reappointed party head in 1984), who was made director general of the Science and Technology Agency.

However, internal leadership squabbling and the grass-roots organizational problems that continued to plague the party led to the NLC's demise, aided by its dependence on a "floating vote" in the Tokyo metropolitan area. (Upon its dissolution, NLC members were welcomed back into the LDP fold.) But as Professor Curtis observes, the party did play an important role in Japanese politics during its 10 years of existence because it deprived the opposition of the opportunity to exploit public antagonism toward the LDP concerning the Lockheed scandal. It could be argued that the NLC also made the LDP more responsive to urban interests, from which the splinter group appeared to be making the biggest draw, but evidence suggests that the ruling party had already begun to adapt to the rural-urban migration.⁷

Most important, the NLC serves as a model, or an example, of what can happen to a new, minor party if its mission is unclear and its local organization is inadequate. Whenever the LDP or any of the opposition parties flirt with the coalition concept, the NLC's rocky experience no doubt offers cause for caution.

Impact on the Policymaking Process

The opposition parties have never held the reins of government power, but as the above suggests, they have not been totally excluded from the policy-making process. Their existence, in fact, has created friction in the party system, which, in turn, has forced the ruling party to grease the wheels of the legislative process. This was particularly the case in the 1960-70 period when the margin by which the LDP controlled the Diet was much smaller than it is today. The opposition parties offer alternative views and policies that the electorate is free to choose if it perceives that LDP policies are at variance with its wants and needs.

In short, potential voter backlash provides a powerful disincentive for the ruling party's resort to a "tyranny of the majority." Just because the opposition has been "enervated" does not mean that the LDP can totally disregard its views. Today's LDP may enjoy a new-found strength, but it has become so dependent on the support of a diverse social coalition that fear of alienating any significant element within this coalition acts as a powerful check on ruling party policies.⁸

As history has shown, whenever the ruling party has attempted to railroad through policies that are opposed by substantial segments of the population, the public has protested -- literally and figuratively, in the voting booth and even in the streets on occasion. The most dramatic example of public outcry was in 1960 when then Prime Minister Nobusuke Kishi attempted to ram the revised U.S.-Japan Security Treaty through the Diet. This precipitated what is widely regarded as the largest public protest in Japan's political history. At that time, wartime memories were still quite vivid and the JSP's call for unarmed neutrality enjoyed broad support. Although the electorate obviously believed that the LDP was better suited to rule the country than the Socialist party, voters nevertheless balked and staged massive demonstrations when they felt the ruling party was going against the grain of national sentiment.

⁷Curtis, op. cit., p. 35.

⁸Ibid., p. 37.

A more recent example involves the ruling party's efforts to enact a national sales tax. In 1986, when then Prime Minister Yasuhiro Nakasone was reveling in the LDP's massive landslide victory in that year's elections in both houses of the Diet, he attempted to take advantage of the ruling party's resurgent popularity by pushing an indirect sales tax through the Diet. This initiative galvanized the opposition parties to an extent not seen in recent years.

Prefectural-level by-elections in the spring of 1987 were transformed into referenda on the prime minister's tax proposal. The opposition parties pounded on the ruling party, accusing the prime minister of breaking his July 1986 campaign promise not to levy new, large-scale taxes. In voting booths around the country, LDP prefectural-level politicians were voted out of office. The ruling party dropped a total of 105 seats, ending up with 1,382 of the 2,670 at stake in 44 prefectures. This was just under the LDP's all-time-low total of 1,391 seats in 1975. In one highly publicized race in Iwate prefecture, the JSP, in particular, made impressive gains.

In addition to working changes at the grass-roots level, the opposition parties also paralyzed all Diet action on the fiscal 1987 budget and, as a result, forced a number of other issues to be shelved, such as the cabinet's decision in January 1987 to discard the decade-old policy of restricting defense expenditures to 1 percent of GNP. The deadlock was finally broken when the LDP leadership agreed to separate tax matters from the budget bill and submit them for later consideration by a panel that would include opposition party representatives. In a major defeat for Mr. Nakasone, the opposition subsequently forced the ruling party into yet another concession -- withdrawal of the 5 percent indirect tax proposal in order to facilitate consideration of the overall tax reform package.

Prime Minister Noboru Takeshita has faced similar tactics this year as he has attempted to pick up where his predecessor left off in proposing a broad-based consumption tax. At the prefectural level, he was tested in Fukushima, where the JSP threw its support behind a former LDP construction ministry bureaucrat in return for his campaigning against tax reform (see JEI No. 34B, September-2, 1988). Although, ironically, the candidates reportedly avoided discussing the indirect tax throughout the campaign, the LDP was concerned that a JSP victory would lend credence to the anti-tax arguments espoused by the opposition parties and undermine the already shaky base of public support for the consumption tax. The ruling party's subsequent victories in Fukushima were therefore portrayed as a boon to the prime minister's controversial tax proposal (see JEI Report No. 35B, September 16, 1988).

However, the opposition has not let up the heat concerning Diet consideration of tax reform. Through repeated boycotts the opposition parties have delayed for at least two months consideration of tax legislation that was ready for Diet consideration July 18. (An extraordinary Diet session was convened July 19 for the express purpose of considering the tax reform legislation.) Recent revelations of questionable stock transactions involving aides to top political leaders of the LDP and the DSP provided the opposition with a stall tactic. Its insistence that officials from the company involved be called before the Diet for a special hearing on the matter has delayed work on the tax bills.

In addition, the opposition parties have insisted that the currently proposed 3 percent consumption tax be separated from the package of bills involving other tax changes, so that Diet action on tax cuts (which they favor) can proceed in a more expeditious manner. Finally, at least for the moment, the opposition parties have dug in their heels and forced the ruling party to agree to a shorter extension of the extraordinary Diet session than it wanted in the hope that time will simply run out. The only party that has demonstrated a limited willingness to cooperate with the ruling party is the DSP. Whether the LDP can co-opt the Democratic Socialists on this issue -- and whether the participation of one opposition party will satisfy political appearances of at least limited consensus -- are open questions. At this point no one is taking any bets on whether the LDP can secure enactment of its tax reform package.

The opposition parties' influence in the Diet is more than procedural. Over the years the opposition also has affected the policymaking process through members' leadership of various committees. Diet rules require a party to have more than a simple majority of seats in order to control legislative committees. Fourteen of the lower house's 16 standing committees have an even number of LDP and opposition party members. Since committee chairmen are allowed to vote only to break a tie, a party must command a majority of two seats in each of these 14 committees if it is to control both the chairmanship and the majority of seats.

In the years when the LDP and the opposition parties had near parity in the Diet -- particularly during much of the 1970s -- the LDP's overall majority was not reflected in several key committees, which they did not control. For example, as a result of the 1972 lower house election, an election in which the LDP secured only 271 of the 491 seats, the ruling party had to relinquish the chairmanships of several special committees for the first time. In 1976, however, when the LDP majority dropped to 257 of the 511 seats, it had to give up the chairmanships of four of the 16 standing committees and seven of the nine special committees. It also lost the majority of seats on seven of the standing committees.

This had a significant impact on policy, particularly since one of the committees on which the LDP lost its majority was the budget committee. When the national budget was submitted to the committee in February 1977, the opposition parties refused to let it pass unless the government agreed to provide more money for social welfare as well as a trillion-yen tax cut. The ruling party refused to formally revise the budget, but in order to facilitate its passage the LDP had to accept a separate bill that provided for a ¥300 billion tax cut and allowed for a supplementary appropriation for social welfare programs. Opposition party strength at the committee level forced what was, in reality, the first substantive revision of the government's budget since the LDP came to power.⁹

A similar pattern reappeared in 1979 and 1980 when opposition party presence on the budget committee forced the LDP into hardball negotiations that resulted in substantive changes closer to what the opposition wanted. This greater influence on the policymaking process that the opposition parties came

⁹Ibid., p. 38.

to enjoy through their committee assignments resulted in a decline in the number of bills passed unilaterally by the LDP; the number of ramrodded bills went from approximately 20 percent in the earlier years of undisputed majority to less than 5 percent in the 1977-80 period.¹⁰ Even now that the ruling party has reclaimed control of virtually all of the key committees, this process of interparty negotiation and coordination continues.

The Future: "Permanent Opposition?"

If the opposition parties can influence the policymaking process and even acquire the strength to pose a challenge to LDP dominance, why then have they been unable to break out of their "permanent opposition" status? As suggested with regard to the JSP, its prolonged minority position has sapped its vitality -- and, indeed, the Socialist party may not be the only victim of this tendency. Moreover, the Japanese public has grown so accustomed to LDP leadership that it has difficulty regarding the opposition as capable of forming a viable government.

All of the opposition parties have repeatedly missed opportunities to take advantage of LDP factional infighting. During the early 1980s, for example, when the race for prime minister was hotly contested by Mr. Ohira and former Prime Minister Takeo Fukuda, the opposition could not agree on a strategy. Some were worried that the failure to form a coalition government with disaffected LDP factions would lead to even greater losses in the next election; others, as a matter of principle, could not bring themselves to support an LDP leader for prime minister when their party's entire *raison d'être* had been to oppose the conservative majority.

Continued fragmentation of the political left and center over the years has reinforced the ruling party's lock on government leadership. By choosing to stay stubbornly independent, the opposition parties have allowed themselves to remain divided and conquered.

In terms of voter appeal, the opposition parties are all fighting for a much smaller share of the electorate due, in part, to the LDP's ability to adapt to Japan's rapid economic modernization. The ruling party recognized in the 1970s that in order to retain power it would have to broaden its constituency by becoming more responsive to the needs and interests of the increasingly urban-bound populace. In short, the LDP built a rural/urban bridge. The JSP, on the other hand, allowed its bridge to collapse. The other opposition parties do not appear to have a clear conception of who their constituencies are and, over the years, have simply scrambled for the leftovers, the amorphous group of independent voters.

Since the mid-1970s, however, independent voters have begun to shift their support increasingly to the LDP out of disenchantment with the opposition. Public opinion surveys suggest that this dissolution on the left and center may be contributing to a realignment on the right. But there is greater evidence to suggest that what may really be happening in Japan is a weakening of strong partisan feelings and party identification.¹¹ Approximately 60

¹⁰Ibid., p. 39.

¹¹Ibid., p. 202.

percent of Japanese voters reportedly do not decide whom to vote for until close to election day. They then are more likely to cast an LDP vote because the party is familiar; the opposition does not have a more attractive alternative to offer; and the LDP has been in charge during the Japanese economic success story and, thus, is the safer bet to protect hard-won improvements in living standards. In Professor Curtis's words:

Economic success -- and the intense interest of the rest of the world in learning how Japan achieved it -- has tremendously eroded a Japanese perception of a contradiction between Japaneseness and modernity. This amounts to a fundamental change in Japan's political culture, one that is at the heart of the disintegration of the progressive camp and the new surge in support for the LDP.¹²

Finally, the LDP and the opposition parties appear to have different attitudes and approaches toward what it takes to secure and retain power. Since its earliest days in power, the ruling party's highest priority has been winning elections. The JSP, by comparison, has been more ambivalent about building local organizations and political machines, due in part to its roots in the prewar proletarian movement. The other parties have been handicapped by their size, lack of resources or dependence on other organizations to deliver candidates and voters (i.e., Domei aiding the DSP and the Soka Gakkai helping Komeito).

Conclusion: A Coalition Government?

More recent signs of moderation in the opposition parties have prompted some analysts to speculate on the possibility of a non-communist coalition. Such an interparty alliance would certainly improve the opposition's chances of challenging LDP leadership. As discussed, the opposition generally has worked together as a bloc to oppose tax reform initiatives, both in 1987 and this year. In a rather unprecedented show of cohesion, the JSP, Komeito and the DSP rallied to the JCP's defense earlier this year when Koichi Hamada, LDP chairman of the lower house budget committee, publicly attacked JSP chairman Kenji Miyamoto, calling him a murderer. Opposition party pressure, as well as subsequent bribery disclosures, finally forced Mr. Hamada's resignation.

Both the JCP and the JSP also have been pursuing a softer line in foreign policy, perhaps bringing them closer to each other on a limited number of issues. Most recently, for example, both indicated that they would like to pursue friendlier relations with South Korea, a country toward which both parties have maintained chilly relations for decades. And potential unification of Sohyo and Domei also might pave the way for a reconciliation between the JSP and the DSP.

While these factors point in a potentially unifying direction, such an alliance remains highly unlikely. Personal animosities and ideological/policy differences that originally spawned the parties -- while less intense in the 1980s -- nevertheless still exist. It is simply too high a risk for the opposition to subordinate individual party interests and mini-power centers for the higher, but by no means assured, goal of wresting control from the LDP.

¹²Ibid., p. 232.

What about an LDP/opposition coalition arising from a split within the ruling party? This appears slightly more feasible, given the intense factional rivalries that characterize today's LDP politics, but it is still unlikely. In 1984, when Prime Minister Nakasone was up for re-election, former LDP secretary general Susumu Nikaido attempted to negotiate an agreement with Komeito and the DSP to form a coalition government with himself as prime minister. What apparently nixed the arrangement was not opposition party resistance so much as LDP factional politics: former Prime Minister Kakuei Tanaka would not let his faction, of which Mr. Nikaido was a member, abandon Mr. Nakasone.

The NLC's failure also stands as an example of what can happen once one leaves the political mainstream. Again, the risks of breaking with more than 30 years of political "tradition" far outweigh the potential benefits. Barring a dramatic downturn in the ruling party's political fortunes, precipitated perhaps by adverse developments on the economic front and/or a foreign policy catastrophe, all signs point to a long continuation of Liberal Democratic rule.

For further information, contact Barbara Wanner.

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The views expressed in this report are those of the author and do not necessarily represent those of the Japan Economic Institute.

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Direction Of Japan's Trade Surplus Unclear

Has the contraction in Japan's huge trade surplus come to an end after only five quarters of improvement? That is a subject of heated debate in Tokyo, set off by the report that the surplus in dollar terms inched up in the July-September period from the year-earlier quarter. For now at least, economic policymakers are taking the position that progress on the trade front is just stalled. While acknowledging that exports are on a definite upswing, they point to the healthy gain posted by manufactured imports in the third quarter as proof that Japan's trade structure is still moving in the right direction. The main snag, according to government officials, is the declining world market price of oil. Japan's oil imports increased 5.8 percent between July-September 1987 and the same three months of this year, but lower prices trimmed the bill 11 percent or \$0.5 billion -- more than enough to account for the rise in the third quarter's surplus.

Business economists, however, generally maintain that the days of a shrinking trade surplus are behind Japan. In this view the realignment of the dollar-yen exchange rate has lost its power to narrow the gap between Japanese exports and imports. On the one hand, big exporters have learned to live with the yen in the 120 to 130 range. That adjustment, it is added, is the main reason the volume of overseas shipments expanded 6.6 percent in the July-September period after going up by 2.5 percent in each of 1988's first two quarters. On the other hand, the ability of the strong yen to pull in more imports each quarter has been checked by some slowdown in Japanese domestic growth. The volume of purchases from abroad was 21.5 percent above its year-earlier level in the January-March period, corporate trade watchers note, but in the three months through September, the gain was trimmed to 15.2 percent.

Regardless of their differences over the direction of Japan's trade surplus in the short run, government and business economists agree that the full-year 1988 figure will come in under last year's final tally of \$79.7 billion -- but just barely. Private-sector forecasters certainly would not be surprised if exports topped imports by \$78 billion or \$79 billion since the black-ink entry declined by only \$6.7 billion before widening at midyear. At the same time, simple arithmetic suggests that a \$75 billion surplus is the best that can be expected.

Government officials in Tokyo undoubtedly are worried about how a trade surplus of this magnitude will play in foreign capitals. A potentially bigger problem, though, could be the slow progress in cutting the imbalance with the United States. The bilateral surplus did continue to decline in the July-September quarter, in part, it appears, because last year's turnaround in the Japan-U.S. numbers lagged the course reversal in the overall trade account by one quarter. Even so, Japan's surplus with this country is running only \$4.7 billion behind 1987's record-breaking pace. A straight-line extrapolation of the January-September number puts the 1988 bilateral surplus at \$44.4 billion. But given recent trends in exports and imports, the figure could end up in the neighborhood of \$47 billion to \$48 billion -- much too close to last year's all-time-high surplus of \$52.1 billion to win Japan points in Washington.

Susan MacKnight

Internationalization Of The Yen Advances

What a difference four years can make. In May 1984 Japan agreed, under U.S. pressure, to take measures to increase the use of the yen in international transactions. The thinking, at least to the Americans who pushed the idea, was that increased demand for the yen would raise its value relative to the dollar, which looked overvalued at the time.

The idea did not work, at least not immediately. The yen depreciated against the dollar in the months following the agreement, although in 1985 the yen and other major world currencies reversed course and began rising against the American currency. As a perceived factor in exchange rates, the May 1984 yen-dollar accord has been superseded by dramatic multilateral agreements, such as the Plaza Accord, that have tried alternatively to destabilize or stabilize currency exchange rates -- with varying degrees of success (see JEI Report No. 40A, October 21, 1988).

Japan's Total Trade in Dollar Terms

(in millions of dollars)

	Exports (f.o.b.)	Change Over Year-Earlier Period	Imports (c.i.f.)	Change Over Year-Earlier Period	Trade Balance
1983	\$146,928	5.8%	\$126,393	-4.2%	\$20,534
1984	170,114	15.8	136,503	8.0	33,611
1985	175,638	3.2	129,539	-5.1	46,099
1986	209,151	19.1	126,408	-2.4	82,743
1987	229,221	9.6	149,515	18.3	79,706
1986: I	45,499	18.2	33,005	1.5	12,494
II	53,166	21.5	31,424	-2.1	21,742
III	54,768	24.7	30,153	-3.5	24,615
IV	55,718	12.6	31,826	-5.5	23,892
1987: I	51,464	13.1	31,977	-3.1	19,487
II	56,931	7.1	36,380	15.8	20,551
III	57,855	5.6	38,346	27.2	19,509
IV	62,972	13.0	42,812	34.5	20,159
1988: I	60,296	17.2	44,499	39.2	15,797
II	65,184	14.5	47,331	30.1	17,563
III(p)	67,128	16.0	47,294	23.3	19,834

Japan's Total Trade in Yen Terms

(in billions of yen)

	Exports (f.o.b.)	Change Over Year-Earlier Period	Imports (c.i.f.)	Change Over Year-Earlier Period	Trade Balance
1983	¥34,909	1.4%	¥30,014	-8.1%	¥4,895
1984	40,325	15.5	32,321	7.7	8,004
1985	41,956	4.0	31,085	-3.8	10,871
1986	35,290	-15.9	21,551	-30.7	13,739
1987	33,315	-5.6	21,737	0.9	11,578
1986: I	8,674	-12.4	6,334	-24.1	2,339
II	9,119	-17.3	5,399	-33.3	3,720
III	8,632	-18.5	4,758	-36.8	3,874
IV	8,865	-15.1	5,060	-28.9	3,806
1987: I	7,960	-8.2	4,959	-21.7	3,002
II	8,153	-10.6	5,207	-3.6	2,946
III	8,507	-1.5	5,644	18.6	2,864
IV	8,694	-1.9	5,928	17.2	2,767
1988: I	7,715	-3.1	5,687	14.7	2,028
II	8,164	0.1	5,927	13.8	2,237
III(p)	8,919	4.8	6,285	11.4	2,634

Japan's Trade with the United States in Dollar Terms

(in millions of dollars)

	Exports (f.o.b.)	Change Over Year-Earlier Period	Imports (c.i.f.)	Change Over Year-Earlier Period	Trade Balance
1983	\$42,829	17.9%	\$24,648	1.9%	\$18,181
1984	59,937	39.9	26,862	9.0	33,075
1985	65,278	8.9	25,793	-4.0	39,485
1986	80,456	23.3	29,054	12.6	51,401
1987	83,580	3.9	31,491	8.4	52,090
1986: I	16,696	25.1	6,278	-7.3	10,418
II	20,921	24.3	8,305	25.1	12,616
III	21,280	28.1	7,525	23.1	13,755
IV	21,559	16.7	6,946	10.8	14,613
1987: I	18,001	7.8	6,986	11.3	11,015
II	21,181	1.2	7,592	-8.6	13,589
III	21,628	1.6	8,252	9.7	13,376
IV	22,770	5.6	8,660	24.7	14,110
1988: I	19,859	10.3	10,088	44.4	9,772
II	21,608	2.0	10,451	37.7	11,157
III(p)	23,044	6.6	10,655	29.1	12,389

Japan's Trade with the United States in Yen Terms

(in billions of yen)

	Exports (f.o.b.)	Change Over Year-Earlier Period	Imports (c.i.f.)	Change Over Year-Earlier Period	Trade Balance
1983	¥10,179	12.9%	¥5,855	-2.3%	¥4,323
1984	14,221	39.7	6,364	8.7	7,858
1985	15,583	9.6	6,213	-2.4	9,369
1986	13,564	-13.0	4,918	-20.9	8,646
1987	12,148	-10.4	4,582	-6.8	7,566
1986: I	3,191	-6.9	1,203	-30.7	1,988
II	3,589	-15.4	1,421	-15.1	2,168
III	3,355	-16.3	1,190	-19.3	2,165
IV	3,429	-12.1	1,104	-16.9	2,325
1987: I	2,786	-12.7	1,083	-9.9	1,703
II	3,034	-15.5	1,086	-23.6	1,948
III	3,180	-5.2	1,215	2.1	1,965
IV	3,148	-8.2	1,198	8.5	1,950
1988: I	2,541	-8.8	1,290	19.1	1,251
II	2,706	-10.8	1,308	20.5	1,398
III(p)	3,062	-3.7	1,416	16.6	1,646